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Accounting News And Trends

Hotel Operations in 1956

Reports on Hotel Business Trends for 1956 have been issued by the firms of Harris, Kerr, Forster & Company, and Horwath & Horwath. The former is based on some 400 hotels located in 200 cities and towns, and the latter on 100 carefully selected hotels located throughout the country. Both publications are outstanding examples of thorough industry analysis and should be very helpful to accountants whose clients operate or invest in hotel properties.

As illustration of the value of the information presented in these summaries these two items may be cited. In 1956, the competition offered by the 1,000,000 rooms located in motor hotels caused a decline in room income for hotels in smaller cities in contrast to the rise in income of hotels in the large terminal metropolitan areas. The decline in the proportion of beverage sales to food sales which started in 1951 stopped in 1956. This is significant as the beverage sales are regarded, according to one of the reports, as a sensitive index of the effect of general economic conditions on the spending habits of the traveling public.

Criteria for Judging Materiality

"Some Comments on Materiality" is the title of a professional comment by J. Edward Robinson in *The CPA News Bulletin* of the Maryland Association of CPAs (May 1957) and deals with the concept of materiality with particular reference to that section of Accounting Research Bulletin No. 43 concerned with material income items which, under certain circumstances, may justifiably clear through earned surplus.

Accounting News and Trends *is conducted by* Charles L. Savage, C.P.A. *and member of the New York Bar. He is presently serving on the Board of Directors of the Nassau-Suffolk Chapter of our Society.*

Dr. Savage is professor of accounting and chairman of the Business Administration Department of Adelphi College.

No criteria for determining what is material are suggested. Some accountants might believe 5-10% of net income would be material while others might conclude that even 20% of net income is not material or might consider other factors. Despite this variation, the author questions the desirability of establishing maximum and minimum standards and states that individual situations are so variable that the question of materiality must be considered in the context of a particular situation. He believes definite benefit could be derived from the gathering of more information in this area with perhaps the publication of case studies where the specific factors leading to the determination of materiality would be clearly stated.

Annual Reports to Stockholders

An article on "The New Look in Annual Reports" by Thomas Kenny (*Dun's Review*, January, 1957) emphasizes that corporations are making a real effort to cultivate the good will of their stockholders and suggests ways of achieving this objective. The need for new capital by corporations and the increased interest of the ever-growing number of stockholders are factors which have contributed to this development.

Those corporations with good stockholder relations present considerably more information than is required by the SEC. They also furnish it continuously and surveys show that the quarterly report is more popular than such stockholder "gimmicks" as plant visits or local meetings. The best practice is to report fully on both good and bad news because oftentimes a warning of impending difficulties saves stockholders from sudden unpleasant surprises. Experience also shows that interpretations of how current and future market conditions may affect their company are more popular with stockholders than detailed information about operations.

The trend in corporate reports seems to be toward the "Ivy Look"—an appearance of quiet dignity with only meaningful illustrations—and away from the expensive, slick,

four-color report. Recent years have seen these improvements in reports:

1. More comparative information. About 85% of the 100 companies included in a special survey, report data for two years, while some one-third gave financial comparison for 10 years or more.

2. The inclusion of a short, nontechnical summary of the year's operation. About 55% of companies now do this as compared with 11% in 1941.

3. Increased use of graphs or charts. About one-half of today's reports contain them as compared with only 8% twenty years ago.

The article suggests the avoidance of these mistakes in preparing corporation reports:

1. The omission of any discussion of new developments in plant facilities and labor relations and the failure to include a general prediction of future operations.

2. The failure to include a table of contents in the report.

3. The unnecessary use of financial jargon without explanation, or the use of pictures which are not related to the text of the report.

The survey also reveals that the issues most often raised at stockholders' meetings—executive compensation and advertising expenditures—are practically never mentioned in reports and raises the question as to whether this information should not be included.

The Queen's English

An editorial in the March, 1957 *Accountants' Journal* (England) entitled "The Queen's English" is worthy of comment. British and American accountants face many similar professional problems but the most striking is the common lack of mastery of the English language in preparing accounting reports. Phrases used should be "clear, concise and appropriate to the occasion" yet oftentimes reports seem to require an interpreter. This deficiency in the handling of English is not confined to accountants but seems to extend to a majority of British undergraduates. In an effort to improve the situation, the oldest professional body in the world, the Institute of Chartered Accountants of Scotland, has recommended the addition of a special subject of précis writing to the professional syllabus.

Reporting to Employees

"What Every Employee Should Know," the lead article in *The Accountant* (England, March 2, 1957) summarizes a survey pub-

lished by the British Institute of Management on what financial information is being furnished to employees and how it is being presented. Over one-half of the companies replying to the questionnaire do give employees financial information. The three usual methods are through the house organ, circulation of the annual report, or a special employees' report. Many firms supplemented the written report with a special meeting at which questions concerning the report could be raised.

The type of information circulated was very similar to that given stockholders—comments on balance sheet and income statement, sales analysis, a forecast of future trading prospects, etc. This was true despite the fact that nearly all employees were definitely more interested in detailed information about their own departments, including cost figures, and plans for new developments rather than in overall profits. Such information was usually not presented for fear of competitors obtaining and using this information, but the survey suggests that if this difficulty could be overcome employee interest in the reports would be materially increased.

Internal Audit of Payroll and Accounts Payable

"Internal Audit and Control of Payroll and Accounts Payable" is the title of the 54-page Report No. 4 issued in 1957 by the Research Committee of the Institute of Internal Auditors. Since payroll and accounts payable are frequently handled by machine equipment, the booklet confines its main discussion to this type of situation. With respect to internal auditing, however, the utilization of machines brings about some change in emphasis in the audit program but not in the fundamental requirements, so that the principles incorporated in the report can easily be applied to those situations in which machines are not used.

The report is based upon detailed operating procedures and the internal audit programs of six companies in diversified fields of business. It includes sections on: accounting machines and control, control of payroll, internal audit of payroll, accounts payable procedures, internal audit of accounts payable, and considerations in the internal audit of a machine department. Some of the following comments on certain phases of the internal audit program are of interest.

1. Observations should be made of employees "clocking out" and a regular routine of observation should be established.

2. The observation of both the "clocking in" and the "clocking out" should be as fre-

quent as the testing of payroll-check deliveries.

3. Internal auditors should make a personal check of the attendance of employees while at work.

4. Proper purchasing procedure provides for competitive bids or some other assurance of a fair price.

5. The survey revealed that many companies either do not reconcile vendor's statements with the accounts payable record or confine this procedure to past-due accounts.

Alternative Accounting Methods

In "Precise Criteria Needed in Evaluating Accounting Alternatives" (*Accounting Review,* April, 1957) Mr. Kenneth S. Young raises the question of whether too much freedom is given practitioners in the acceptance or non-acceptance of accounting methods. He suggests the need for more objective standards in selecting alternatives and questions the wisdom of allowing the accountant complete independence in determining whether a particular practice is in accordance with generally accepted accounting principles.

The author believes that in certain situations logic requires that only one method can be correct but the accountant finds little help in selecting the proper alternative in the statements of broad concepts issued by the profession. Accounting texts are no better guides since they usually summarize reasons for each possibility but fail to state specifically under what circumstances a particular method would be acceptable.

To Whom Do Internal Auditors of Banks Report?

The *Controller* (March, 1957) reports on an informal survey made of seven of the larger banks in the New York-Philadelphia area on the question "To whom do internal auditors make their periodic reports—the President or Board of Directors?" In conducting the survey certain other information concerning the internal auditor was also obtained. There was a wide variation in practice followed by this fairly homogeneous group of banks. The points covered and a summary of the answers follow:

Internal auditor mentioned in by-laws—5 No; 2 Yes. Internal auditor is comptroller—4 No; 3 Yes. Internal auditor is assistant comptroller—6 No; 1 Yes. Internal auditor reports to—President, 1; President and Board of Directors, 3; Comptroller, 2; Chairman of Board or President, 1.

The Business Situation in New York State

Accountants may wish to have their names placed on the mailing list of the New York State Department of Commerce to receive the monthly "Commerce Review." In addition to authoritative articles about different New York State industries—the March, 1957 issue, for example, has a 12-page description of the electronics industry—the publication contains a page of current business statistics and a one-page summary of "The Business Situation" in New York State. The review represents a convenient way of keeping abreast of current conditions in the State and can be obtained by writing to the Department of Commerce, 112 State St., Albany 7, N. Y.

Attorneys and the Meaning of the Short-Form Report

In the *American Bar Association Journal* (March, 1957), Mr. Louis S. Goldberg explains to his fellow attorneys* "How to Read CPA's Certificate and Report." The article contains a technical exposition of the meaning of the certificate and includes a complete chronology of the development of the short-form report. The author, who is also a CPA, comments on the need for attorneys to be aware of the existence of a complex body of accounting theory governing the form and content of the short-form report or *opinion*, and urges his colleagues to seek accounting counsel when in doubt.

Operating Ratios

As a result of a change in policy, the *1955 Statement Studies* of the Robert Morris Associates will now be available for general distribution.

The *1955 Statement Studies* consists of Part I—The Basic Study which contains composite financial data on 143 lines of business (80 manufacturing, 37 wholesale, 26 retail) and Part II—The Income Supplement which covers information on "Selling & Delivery Expense," "Officers' Salaries," and "Other General Administrative Expense" on 116 lines of business. The Studies are common size composite financial statements with a group of ratios setting forth the averages of individual collected statements.

Although prepared for the use of bank loan officers and other credit grantors for purposes of comparison with specific companies, the operating ratios can be very helpful to accountants in financial statement analysis. Copies may be obtained at a cost of $10.00 each from the Robert Morris Associates, National Bank Building, Philadelphia 7, Pa.

An Adirondack View

Annual Reports of corporations whose stock is widely held as investments are interesting. They are built to sell their products to their own stockholders—and sell other ideas. But, our special scientific (!) survey was the CPA opinions attached. We found as follows:

1. No auditor's opinion—4 reports. A general insurance company, and 3 state banks in 2 different states.

2. Opinion by a firm of Auditors and Accountants; this firm not registered as CPAs in New York—2 reports.

3. Opinion signature as CPAs but no name and CPA heading—3 firms and 3 reports including one Canadian as a C. A.

4. CPA in opinion heading but not after signature—3 firms and 6 reports.

5. CPA in heading and also after signature —2 firms and 3 reports.

6. No mention in the opinion anywhere that the auditors were CPAs even though they are so registered in this State—3 firms and 12 reports.

Some years ago we got a complaint that an audit report of ours was not signed as a CPA—it came from that tall city on the big island near the mouth of the Hudson River. Our reply was that our letterhead showed that we started the report as a CPA and couldn't possibly be anything else at the end. Yes, we had to use a lawyer to collect our bill.

Well, this survey of 30 reports for 1956 isn't too extensive, but it does show very real variations. Since we ask for a "disclaimer" when a CPA makes a report without an opinion, perhaps we should ask for a professional designation when a CPA does give an opinion. Some stockholders might get the idea that the audit was done by a plumbing concern!

LEONARD HOUGHTON, CPA
Saranac Lake Branch of
the "Adirondack Chapter"

Letters to the Editor

Toward Better Credit Grantor—CPA Relationship

The January, 1957 issue of *The New York Certified Public Accountant* contains an article by Mr. H. P. C. Howe, Executive Secretary of The New York State Society of Certified Public Accountants, which has an important bearing on the letter which I am addressing to you. Mr. Howe's article is entitled, "A Public Relations Program for CPAs."

Another article in the same issue by Mr. Garrett T. Burns, "How Can Bankers Obtain Information About CPAs?" suggests what should be done to cultivate a better relationship between the practitioner and the banker.

A third article reported on under the caption "Open Sesame" in the March, 1957 issue, in the *Accounting News and Trends* department conducted by Dr. Charles L. Savage, outlines procedures for obtaining bank loans.

These articles have the common purpose of bringing together the practitioner and the credit grantor.

It was my privilege and pleasure, as a Vice-President of The New York State Society of Certified Public Accountants, to be present at two dinner meetings of the Textile Division of the Credit Men's Association and the bankers' credit organization — the Robert Morris Associates. At these meetings there were discussed problems which confront credit grantors in their analyses of the financial statements examined by credit seekers' accountants.

One of the subjects discussed was that in some instances the CPA, whose name appeared on the opinion statement, was unknown to the credit grantor. I believe that this problem arises mostly in the Metropolitan area; in other areas, accountants and credit grantors meet at social, business and professional functions, thus creating a personal relationship.

Although the Society arranges meetings which members of both groups attend, it is not possible in such a large assemblage for all those present to get to know one another.

The following suggestions might be effective in establishing a closer relationship between the credit grantor and the accountant:

1. If the accountant is unknown to the credit grantor, the client, when apprised of this fact, should suggest that the CPA be contacted.

2. It is good public relations for the practitioner, with the knowledge and consent ment with the credit grantor.

3. It is also good public relations for the practitioner to introduce himself to the credit grantors of his client. Such face-to-face meeting will enable the practitioner to move from the "unknown" to the "known" category. It will present an opportunity to learn what information the credit grantor requires which, when furnished, may be of assistance in establishing credit.

The old adage "Out of sight, out of mind" still holds true. By participating in Society technical committees, a member widens his acquaintanceship with fellow practitioners and they in turn can be favorably informative regarding the unknown accountant.

The practitioner may hesitate to meet with a credit grantor because the scope of his examination was limited by the client. However, if such limitation does exist, there should be no reluctance on his part to explain it. After all, the credit grantor is extending credit, either in the form of money or merchandise; consequently, if there are limitations with regard to the examination of the financial statements, the credit grantor can, and doubtless will, suggest to the credit seekers the wisdom of removing them.

Often credit grantors who serve the textile industry request interim trial balances to assist in arriving at credit judgment. The practitioner, with his informed judgment of the financial transactions, can serve his client well by discussing these interim figures with the credit grantors.

Bank borrowings in this day of tight credit are more difficult to obtain, and, where obtained, to continue. The esteem with which the banker regards the CPA is in many instances a contributing factor in the favorable weighing of the financial statement.

The credit grantor should know whether the practitioner is a member of The New York State Society of Certified Public Accountants, the obligation he undertakes when

he joins, and the rules of ethics to which he subscribes.

Inquiry was made at one of the aforementioned dinner meetings as to the attitude of the Society in cases where misleading statements have been presented. It may be opportune to say that the by-laws of the Society and the Accounting Law of the State of New York are very stringent. These make provision for acting on written complaints against CPAs relating to unprofessional conduct in the areas of fraud, deceit or gross negligence in the public practice of accountancy. The Society's by-laws provide for the admonition, censure, suspension for a designated period, or expulsion. The Accountancy Law goes a step further, namely, withdrawal of the CPA certificate.

I can well understand the magnitude of the problems confronting the credit grantor; perhaps the suggestions outlined above will prove constructive.

CHARLES HECHT, CPA
New York, N. Y.

Amendment of State Banking Law Provides for Bank Audits by Independent Accountants

During the 1957 session of the Legislature, Section 122 of the Banking Law of the State of New York was amended to read as follows:

"Section 1. Section one hundred twenty-two of the banking law, as last amended by chapter one hundred ninety-seven of the laws of nineteen hundred thirty-nine, is hereby amended to read as follows:

"'Sec. 122. Examinations of banks and trust companies by directors; employment of assistants. It shall be the duty of the board of directors of every bank and every trust company once in each calendar year to examine, or cause a committee of at least three of its members to examine, such bank or trust company for the purpose of determining its financial condition and reviewing its investment, loan and audit and control policies and in such examination particular attention shall be given to the loans or discounts made directly or indirectly to its officers or directors, or for the benefit of such officers or directors, or for the benefit of other corporations of which such officers or directors are also officers or directors, or in which they have a beneficial interest as stockholders, creditors, or otherwise, with the special view of ascertaining their safety and present value, and the value of the collateral security, if any, held in connection therewith, and to such other matters as the superintendent may require. Such directors shall have the power to employ such assistants in making such examination as they may deem necessary, and shall employ the assistance of independent auditors if the superintendent deems inadequate the internal auditing and control procedures established by such bank or trust company. With the approval of the superintendent, the various offices, departments and phases of business of any such bank or trust company may be examined as of different dates during the year.

"'Par. 2. This act shall take effect immediately.'"

The provision with respect to the employment of independent auditors is of particular interest. The statute recognizes the need for assistance by independent auditors. This should present further opportunities to our profession to render additional services to the banking industry.

FRANCIS E. JASPER, CPA
Chairman, Committee on Banks and Savings Institutions Accounting

Uniformity in Rules of Professional Conduct

A Reply Comment by the Chairman of the Institute's Committee on Professional Ethics

In a Letter to the Editor published in the May 1957 issue of *The New York Certified Public Accountant*, Mr. William J. Seif of New York referred to the new rules of professional conduct as proposed by the ethics committee of the American Institute of Accountants. In his timely and interesting letter Mr. Seif made two points: (1) that the present rules would be strengthened if universally adopted by all State Societies; and (2) that there is a wide variance between the rules of the professional societies and those of the regulatory bodies, particularly the S.E.C.

The American Institute of Accountants' committee on ethics agrees in principle with Mr. Seif's first point. Prior to the April meeting of Institute council the committee sent copies of the proposed rules, together with an explanation of their purposes, to all State Society presidents and to all Society ethics committee members. The response was substantial, critical, and convincing. There was so much objection, in fact, to proposed rule 18 (competence to supervise) that the committee withdrew the rule for further study. Certain changes in wording were made in other rules.

If an effort were made at this time to obtain the adoption by the Institute and the State Societies of a uniform set of rules of professional conduct it would indicate, would it not, that the profession as a whole is satisfied, generally speaking, with their present rules of conduct? Certainly it would be much

more difficult to change a rule once it had been adopted by fifty or so Societies not to mention State Boards of Accountancy. It is the Institute committee's view that our present rules of conduct are inadequate.

In his recent book on the subject, Mr. John L. Carey wisely points out several areas of practice to which at present no rules of conduct apply. In a most readable article in the *Journal* a year or so ago, Mr. Mark Eaton expressed the view that our present codes pertained only to auditors and made little if any reference to tax work, management services, or other areas in which our members now serve. Late in 1955 the A.I.A. ethics committee was expanded from five to fifteen members and sub-committees were set up to formulate new rules of conduct in the various areas.

Rules of conduct are not easy to write. The natural tendency is to make them too long; the longer the rule, the more difficult the interpretation and the more loopholes to be found. If they are too short they leave too much room for interpretation by the committee or they merely state the obvious, *e.g.*, a member shall be independent, or, a member shall be competent. Sometimes I think that we are in the single-entry bookkeeping stage when it comes to writing rules of professional conduct. Perhaps we should make a new approach.

Why not begin our rules with a preamble in which we state in broad outline the philosophy of a CPA; in this we could have something to say about independence and competence. Then would follow concise general rules; these rules, of course, would be approved by the membership. The rules would then be buttressed and amplified by a set of official "regulations" in which the rules were interpreted in some detail; these interpretations should be approved by Institute Council or Society directors. And finally, there would be case studies or releases by the ethics committees in which the manner of enforcement of the rules was indicated. Within such a framework should be found the solutions to many of the problems which today vex the members as well as the ethics committees.

The profession has little control over the rules of conduct as promulgated by S.E.C. and other regulatory agencies. It follows then that a goal of uniformity between our code and theirs would be a bit impractical. It is the ambition of the Institute ethics committee to broaden and strengthen our present rules of conduct; if the rules are soundly written we should, eventually, approach uniformity.

Frank L. Wilcox, CPA
Chairman, Committee on Professional Ethics, American Institute of Accountants

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

***ADDRESS FOR REPLIES:** Box number, The New York Certified Public Accountant, 677 Fifth Avenue, New York 22, N. Y.*

HELP WANTED

CPA, preferably with retail credit jewelry experience, to be comptroller for a progressive mid-west chain, minimum salary $10,000.00, no traveling. Box 1167.

Instructor, in accounting at college in metropolitan area, must be CPA, teaching experience and graduate degree preferred. Box 1170.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $6.50 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Justin Jacobs, investment information, portfolio analysis, no charge for these professional services. DIgby 4-7140, 42 Broadway, New York 4, N. Y.

Statistical Typing, IBM typography, offset printing. Gitsham's, 480 Lexington Avenue, N. Y. 17, PLaza 5-6432.

CPAs, N. Y., N. J., Conn., W. Va., AIA, established over 20 years, heavy taxes, management (IE, MBA), substantial cash, seek practice, accounts. Box 1156.

CPA, N. Y., N. J., AIA, heavy taxes, management, (IE, MBA), substantial cash, seeks practice, accounts. Box 1157.

CPAs, partnership level experience (auditing, systems, taxes), seek to purchase medium sized practice, in N. Y. C. metropolitan area. Box 1158.

CPA, offers residence, adjoining office and local practice for sale to CPA in fast growing Suffolk County town. Box 1159.

CPA, has suite in fine midtown building to share with or without services. Box 1165.

CPA, gross $20,000.00 wishes partner approximate $15,000.00 or more. Box 1166.

CPA, with office and residence in N. Y. C. and now doing work for upstate CPA firms

BUSINESS OPPORTUNITIES

wishes further connections with out-of-town accounting firms. Box 1168.

One or two large offices, in seven room modern suite for accountants, one office has separate entrance, secretarial space optional, $85. Minkoff, 276—5th Ave (407).

SITUATIONS WANTED

CPA, age 40, 20 years public experience in all phases of accounting, with emphasis on institutions, nonprofits, fund raising, hospitals, investments, funds, real estate, seeking part-time or per diem work. Box 1160.

Immediately Available, accountants, office managers, bookkeepers. Bookkeepers & Accountants Division, Maxwell Employment Agency, 130 West 42nd Street, N. Y. C., telephone LOngacre 4-1740.

Assistant Comptroller, CPA, law degree, presently employed, seeks better opportunity, over 25 years diversified experience, public and private, office management, financial statements, internal controls, credits and collections, taxes. Box 1161.

CPA, 13 years public accounting and tax experience, earning $10,000., seeks association with overburdened or retiring practitioner or firm with potential growth to partnership status. Box 1162.

CPA, Society member, 20 years diversified public experience, thoroughly experienced audits, taxes, available 12 days monthly, per diem. Box 1163.

Tax Accountant—Attorney, M.B.A., former revenue agent, tax writer, researcher, seeks full-time or part-time employment. Box 1164.

CPA, N. Y., 29, family, background as controller, budget director, plus public experience, member AIA, State Society, National Honor Fraternity, desires responsible accounting position with progressive industrial firm. Box 1169.

The President's Page

The Value of Ideas

At the Annual Meeting of the Society on May 13th I expressed my belief that every member should be aware of what is going on in our profession and our Society, and should contribute to the progress of both. As in the past, the membership will be kept fully informed and this Page, which may appear only periodically, will be but one of the many media employed for that purpose.

Progress depends largely upon the interchange of ideas. Communication to be effective must operate both ways. We will be far more successful in advancing the interests of the Society if the views of our members are made known to the officers and directors. More and more, recognition is being given to the value of ideas—no matter how extreme. For, from the unusual and seemingly impractical may develop something sound and constructive.

A revival of an old idea is frequently as fruitful as one which has a novel slant. Some time ago I reviewed a file of minutes of the meetings of the Committee on Furtherance of the Objects of the Society covering a number of years in the 1930's. I was amazed to note how many matters considered then had been reconsidered in later years and, more astonishing, how many of the projects tabled at the time, or even disapproved, had later been found practicable and had been adopted. The Society's Benevolent Fund, just to mention one, was a matter considered many times before it was finally created a few years ago. The fact that an idea has been considered before should not disqualify it from reappraisal in the light of current conditions.

Some of the suggestions, though seemingly sound on their face, may upon closer scrutiny prove impractical. But whether old or new, practical or impractical, they will be welcome; and they will be given careful consideration because this is your Society and its advancement is our mutual concern.

LEONARD PRICE,
President

A New Look at Accountants' Legal Responsibility

By SAUL LEVY, C.P.A.

The issuance of a long-form report carries with it implications involving accountants' legal responsibilities which, heretofore, have not been clearly defined. The author, in discussing the theoretical aspects of these and other current problems, likewise calls attention to such practical considerations as the adequacy of liability insurance coverage.

In recent years there has been a sharply awakened interest and an increasingly realistic approach to our problems of legal responsibility. This has been in marked contrast to the escapist attitude of earlier decades. The feeling used to be that the least said on this subject, the better. Very little attention was paid to it in our textbooks on auditing and probably even less attention in our classrooms. When a new case appeared, the court's opinion would be published in our periodicals with an editorial discussion which, to the general public, often implied that our profession felt that it was against the public interest to impose liability on the accountant for anything short of deliberate fraud. It did not occur to many of us that these judicial opinions were source material that should be analyzed and studied and that from them a road map could be drawn up which might help us find our way in greater safety in the future.

SAUL LEVY, C.P.A. *and attorney, is a past President of our Society and the author of the A.I.A. publication, "Accountants' Legal Responsibility."*

This article has been adapted by the author from a paper presented by him at the April 25, 1957 General Meeting of our Society.

The Growth of Professional Literature

In 1945 when the Institute published *Contemporary Accounting*, which was intended primarily as a practical refresher course for returning servicemen whose accounting practice had been interrupted, there was so little general interest in the subject that there was scarcely any mention of it in that comprehensive work. By contrast, in 1952 the *CPA Handbook*, also published by the Institute, contained a lengthy chapter entitled "Legal Responsibility and Civil Liability." This was soon followed by the publication of the book, "Accountants' Legal Responsibility," which brought together for the first time a reprint of all of the known cases in the American courts.

Since then, the *Journal of Accountancy* has published a series of articles on such

broad topics as working papers, long-form reports and internal control, directed toward the practical objective of minimizing the hazards growing out of legal responsibility. About a year ago, the Education Department of the Institute set up a Seminar Course on the subject, which was held in New York in the spring of 1956 and repeated in the fall under the auspices of the New York State Society of Certified Public Accountants. The course was also given in Chicago and it is contemplated that it will be offered in many other parts of the country. The response to it has been uniformly enthusiastic.

Back of all this educational endeavor has been the conviction that the more that we understand the nature and impact of our legal responsibility, the better will we be able to avoid trouble for ourselves. In the final analysis, such trouble can be avoided only by the faithful and competent discharge of our professional duties with full realization on our part of the legal-responsibility implications in our professional work. Thus, as we safeguard our own professional position, we at the same time best serve our clients.

Implications of Statement No. 23

An excellent illustration of what I am trying to point out is seen in the implications of *Statement No. 23* in the series of *Statements on Auditing Procedure* promulgated by the Institute. With any report or statement with which he is identified, an accountant is now required to add his unqualified opinion, his qualified opinion, or to express his denial of any opinion with his reasons therefor. The original purpose of this requirement was to discharge our responsibility to members of the public who might read that report or statement and be misled if there did not appear in it a clear expression of the responsibility which the accountant assumed with respect thereto. That was our primary objective, namely, to give fair protection to those who might otherwise assume that because a statement or report appeared on a CPA's stationery, it carried with it the accountant's opinion that it was a fair presentation. Our present rule accomplishes that purpose.

It is often not appreciated, however, that *Statement No. 23* at the same time serves importantly to protect the accountant against creating the appearance of assuming responsibility which he does not intend to assume. Stated otherwise, the accountant is now required in every instance to state clearly and unequivocally precisely what degree of responsibility on his part attaches to the issuance of the statement, whether it carries his unqualified opinion or only his qualified opinion, or whether he disclaims any opinion whatsoever with the reasons for such disclaimer clearly stated.

Fact vs. Opinion

Our present short-form standard certificate has developed in response to our study and analysis of the cases dealing with accountants' responsibility. In the initial scope paragraph appears the only representation of fact that is ordinarily set forth in the certificate, namely, that we have examined the enumerated financial statements and that our examination has been made in accordance with generally accepted auditing standards.

In the opinion paragraph which follows, we express our opinion that the statements are a fair presentation in conformity with generally accepted accounting principles.

This is a carefully worded document which differentiates sharply between representations of fact and expressions of opinion, and in both categories ties

in with the procedural standards and the technical concepts which we ourselves have established for our profession. In this way we seek to have our work judged by our own standards and not by the notions and ideas of the laymen who may be sitting in the jury box.

The Long-Form Report

Though we have accomplished a great deal in recent years toward keeping our civil liability within professional bounds in the area of our short-form report and the standard opinion accompanying it, we have not yet made similar progress in the area of the long-form report which is very generally used. This matter has been under intensive study by committees of the Institute and a Bulletin on the subject is due to be issued in the near future.

The long-form report is characterized by the inclusion of numerous comments which often fill many pages of the report. These comments, in part, describe the audit procedures followed and as such may be regarded as an amplification of the scope paragraph in the short-form standard opinion. In addition to the matter relating to audit procedures, however, there appears an infinite variety of material bearing upon the financial statements themselves, such as a breakdown of sales by products, departments or geographical areas, detailed comparisons with prior years and explanatory details relating to various items on the financial statements.

Much of this financial comment may not have been confirmed by audit but may have been taken from the records without independent verification. At the conclusion of the comments there generally appears the opinion of the accountant in the standard language of the short-form report. This opinion generally is directed to the balance sheet, the income statement and surplus account. Nothing is said about the supporting schedules or about the comments in the report, though often there is a notation that the basic statements are "subject to the comments."

In the typical long-form report situation which I have briefly outlined, the accountant may find himself exposed to one or more of the hazards which are outlined in the following discussion.

Long-Form Comments Omitted From Short-Form Report

If he issues a short-form report which is sent by his client to credit grantors, and a long-form report (with numerous explanatory comments) which is intended for the information of the client only, it may later be argued that the short-form report omitted comments of material importance which were contained in the long-form report, and that, as a result, the short-form report was misleading. How material these omitted comments were, may be judged in the light of hindsight long after the reports were issued.

Report Comments Misconstrued as Qualifications

Where both a long-form and a short-form report are issued, it may later be argued that the long-form report contained a qualified opinion because that opinion was subject to the detailed comments in the report. This conclusion may attack the unqualified opinion in the short-form report. This contention that the two reports are inconsistent may seem very persuasive to a jury of laymen who will conclude from it that the accountant deliberately misled the credit grantor through this device of a double-form presentation. This is exactly what happened in the *State Street Trust Company* case. No accountant who has studied that case should inadvertently step into this pitfall.

Comments May Be Regarded As Representations of Fact

Even where the long-form report is the only report issued, the form in which the comments are presented may needlessly expose the accountant to legal danger. Where the opinion relates only to the basic financial statements, it may well be argued that the comments are offered as representations of fact true as of the accountant's knowledge. If the comments are deemed to be representations of fact, then a far heavier legal responsibility attaches to them than if the accountant merely expressed his opinion that the comments were fairly presented.

Startling as it may seem, our highest court in New York has made this sharp distinction between representations of fact and expressions of opinion, namely: where an expert makes a false statement of fact true as of his own knowledge, he will not be exonerated because he believed the statement to be true. Any statement of fact made by an expert without qualification will most likely be considered a statement true as of his own knowledge. Thus, the accountant virtually warrants the accuracy of factual statements as such where he fails to expressly limit his responsibility with respect thereto. On the other hand, if he does no more than express an opinion concerning the comments relating to financial facts, he would adequately meet his responsibility if he complied with generally accepted auditing standards and had a sincere belief that his opinion was well founded. He would not warrant the accuracy of his opinion.

The Long-Form Report and Statement No. 23

Statement No. 23 in effect warns the accountant to take an unequivocal stand with respect to the comments in his long-form report. If the comments were prepared without audit, the report should clearly so state. If the accountant intended to embrace those comments in his opinion, whether it be an unqualified or a qualified opinion, that opinion should be so worded that no doubt is left as to the intention of the accountant. If it was intended to express an opinion concerning the basic statements but to deny any opinion concerning the comments or some of the comments, the report should clearly indicate not only that the accountant denies any opinion concerning the comments but that he does not offer such comments as representations of fact of his own knowledge but, rather, that he is merely presenting them for information purposes only, without any responsibility for their accuracy.

Special-Purpose Reports

The whole question of special-purpose reports and non-standard opinions, including cash basis statements, is another area which requires clarification. Here we have a bewildering variety of subject matter, but many aspects of report presentation can be standardized in a way which will serve to convey more explicitly the accountant's limited responsibility. Here again we may look forward to an Institute Bulletin in the near future.

Liability Insurance

A new look at the incidence of legal responsibility has led the profession at large to interest itself more and more in the protection which may be available through liability insurance. Our state societies all over the country have been particularly active in bringing this matter to the serious attention of its members. It is amazing that despite all this activity and in the face of all its obvious advantages to the practicing ac-

countant, the indications are that approximately half of our practitioners carry no insurance whatsoever. In a very recent survey made by the Institute, a questionnaire to all firms and individual practitioners represented in the Institute resulted in over 2,000 replies. Of this number, 48.5% indicated that they were not insured and 31.5% of those who were insured, replied that they carried only the minimum amount of insurance, which is $20,000.

Even if an accountant is destined to go through professional life doing flawless work only, and even if every member of his staff is also similarly infallible, his work might be unjustly and unfairly criticized and a claim pressed against him. It would be necessary for him to defend himself, no matter how blameless he might be. If he carried insurance, the cost of that defense would be assumed by the insurance company, which of itself supplies reason enough to carry insurance.

The cost of such insurance, which of course is tax deductible, is so reasonable in relation to the protection afforded that it is difficult to understand why any practicing accountant should limit himself to the minimum $20,000 coverage. No matter how small the client may be from the standpoint of the fee which he pays, the amount of the claim which he or his credit grantor may later assert against the accountant, has no relation to the fee involved and may amount to 50 or 100 times the fee paid to the accountant, or much more than that.

Insurance Coverage and Legal Fraud

In the survey referred to above, members of the Institute were asked whether they availed themselves of premium reductions by waiving coverage for so called "legal fraud". Over 30% of those who were insured said they were not covered for legal fraud. This is a situation which should be corrected without delay. The term "legal fraud" as used in liability insurance policies generally refers to fraud which may be inferred from evidence of gross negligence. It is the type of fraud discussed in the *Ultramares* case where it was said by Judge Cardozo that a jury might find that an audit was conducted with such gross negligence that the accountant could not have had a sincere and honest belief in the opinion that resulted, and that a jury, on the basis of such gross negligence, might conclude that the accountant's opinion was a mere fraudulent pretense. In such circumstances a jury might impose liability on the accountant to a third-party credit grantor on the ground of fraud, even though primarily gross negligence only was involved. That is the type of fraud which insurance companies have termed "legal fraud," namely fraud in contemplation of the law. To deny yourself protection against such legal fraud is to leave yourself uninsured against the possible claims of third parties. It is as if you carried casualty insurance to protect you against personal injury to those riding in your own automobile, but left yourself uninsured as to personal injury to pedestrians or people riding in a car other than your own. Accountants who have been tempted to deny themselves this coverage in consideration for a reduction in their premium, have usually not understood what they were doing.

Legal Responsibility—a Challenge and Not a Threat

In conclusion, it should be stated that certified public accountants should recognize that every profession assumes

responsibilities toward the public which it serves and that the law recognizes and enforces such responsibility. It is a normal and healthy attribute of our own professional activity that it involves such responsibility. It should be regarded primarily as a challenge rather than as a threat. There is no adult reason why we should not accept it as a phase of our work concerning which we should have expert skill and knowledge, as much so as with regard to any other aspect of our professional activity. Nor should we approach the subject from the negative standpoint that these are abnormal hazards which we should seek to eliminate. Rather should we realize that these hazards are minimized to the extent that we do a faithful and competent job judged by our own standards. That is to say, as we best serve our clients, we best protect ourselves against potential dangers which exist if our services do not measure up to our own self-imposed professional standards.

The Nature of Accounting Services

The accountant's responsibility is for the expression of a professional opinion in accordance with generally accepted accounting principles as the result of an examination conducted in accordance with generally accepted auditing standards. The accountant does *not* make factual representations as to the content of financial statements; that is the function of management. He does *not* insure, guarantee, or warrant the accuracy of management's representations, which in turn include matters of estimate, judgment and opinion. He does assume responsibility for his own opinions, and represents, that in order to place himself in a position to express such opinions, he has complied with generally accepted auditing standards, which provide for:

1. *An expert opinion*—implying adequate technical training, proficiency and due care in the performance of the audit;

2. *An independent opinion*—the result of an objective, impartial, and unbiased mental attitude;

3. *An informed opinion*—the result of a proper study and evaluation of internal control as a basis for reliance thereon and for determining the extent of tests in the application of auditing procedures; and based upon competent evidential matter sufficient to supply a reasonable basis for the expression of an auditor's opinion;

4. *A technical opinion*—that the statements are presented in accordance with generally accepted principles of accounting applied on a basis consistent with that of the previous year;

5. *A candid opinion*—that the financial statements are reasonably informative as to all material facts, unless otherwise stated.

from ACCOUNTANTS' LEGAL RESPONSIBILITY *by Saul Levy, American Institute of Accountants, 1954.*

Cost Accounting Under the Robinson-Patman Act

By Otto F. Taylor, C.P.A.

When a Federal Trade Commission complaint, or a private suit for damages, alleges price discrimination, a seller may seek to show that differences in his prices are justified by differences in his costs. The CPA can render valuable service to his client in undertaking appropriate cost studies.

We may all find it easy to agree with the idea that cost is the most important factor influencing the price level not only of a community or an industry but of a particular concern. Experience teaches us, however, that prices for specific articles in stipulated quantities to particular buyers are governed by many factors of which cost is only one. Custom in the trade, the state of competition, and the individual seller's situation in the market strongly influence his price policy and his price structure. We shall consider here another influence on pricing, namely the antitrust statutes, or rather an accounting provision in one of those statutes.

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The author, who is a partner in the firm of Bacon, Taylor & Beairsto, Certified Public Accountants, served on the Federal Trade Commission Advisory Committee on Cost Justification.

The Legal Background

Before we attempt to focus our attention on the strictly accounting aspects of this subject we may well pause a moment to look at the whole area in which our point of interest is located. We are in the field of antitrust law and, because of the accounting implications, must obtain an adequate understanding of them.

Attorneys who specialize in this field tell us that the object of all the antitrust laws is to protect and encourage competition. The first of these laws, enacted in 1890 and called The Sherman Antitrust Act, declared contracts, combinations, and conspiracies in restraint of trade to be illegal, and an attempt to monopolize to be a misdemeanor. The Federal Trade Commission Act (1914) provided for the creation of the Com-

mission as an administrative and quasi-judicial agency, and declared illegal unfair methods of competition, and unfair or deceptive acts or practices in commerce.

The Clayton Act (1914) contains provisions dealing with a wide variety of trade matters including price discrimination, tying arrangements, exclusive dealing, acquisitions and mergers, etc. That Act also provides for the right of a private person to sue for treble damages, and for equitable relief, where he has been a victim of antitrust violation. Such actions have resulted in recoveries in many court cases in recent years. Naturally the number of settlements out of court is a matter for conjecture.

Section 2 of the Clayton Act, as amended by the Robinson-Patman Act (1936), contained a number of subsections of which Subsection 2(a) dealing with price discrimination is the one which most concerns accountants. Subsection 2(b) places the burden of justifying price discrimination on the person charged with the violation (ordinarily the seller) and authorizes the Federal Trade Commission to issue an order stopping it. Subsection 2(b) also permits a seller to show that his lower price was made to meet an equally low price of a competitor. Subsection 2(c) forbids paying brokerage to buyers. Subsections 2(d) and 2(e) prohibit sellers from paying their customers for services or rendering services to them except on equal terms. Subsection 2(f) makes a buyer equally liable with a seller where he knowingly receives an unlawful price discrimination.

Price Discrimination

From this rough sketch of the background of our subject it should be apparent that the antitrust laws deal with a complex of legal, political, economic, trade, and accounting ideas. Although an accountant as a fact finder and analyst may find himself involved in almost any antitrust proceeding, he is more likely to be concerned with the application of Subsection 2(a) of the Clayton Act as amended by the Robinson-Patman Act than with any other subject in this field. Consequently, before proceeding further, we should examine this subsection in detail. It provides:

"That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them: Provided, That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered."

This provision has been said to require uniform prices, to favor the small buyer, and to foster local monopolies. In actual practice, however, it appears

merely to require like prices for like goods to like customers except where price differences are no greater than specified differences in a seller's costs.

The Nature of the R-P Cost Problem

In recognizing that a Robinson-Patman cost problem has limiting features, we can rid ourselves of needless labor. Initially, it is important to discern that we are not dealing with all prices and all costs but only with certain aspects of price and certain aspects of cost. Consequently, our task does not necessarily require inquiry into all the prices, the entire price structure, or the whole price policy of an industry or even of an individual concern. On the contrary, we ordinarily need to find only price differences for certain goods sold by one concern to competing customers and to compare these price differences with certain specified cost differences.

Illustrations of Non-discriminatory Pricing

A few illustrations may help clarify this matter. Where the seller effects a saving in cost he may or may not reduce his price because there is no requirement that he pass on the saving. If he does share with the customer the benefit of the saving, he need not give the customer all of it. Naturally if the prices do not differ, there is no problem of justification, as, for example, in the case of so-called delivered prices where the seller undertakes to transport the goods at his own cost. Under such circumstances the absorbing of freight charges merely adds to the other costs incurred by the seller without influence on the price of the goods themselves.

Even where prices differ they may not be discriminatory and so may not be subject to cost analysis. They may be wholly intrastate; the goods to which they relate may be unlike; they may apply to customers of different functional status. For example, wholesalers may be granted lower prices than retailers without reference to cost differences where these two groups do not compete with each other. Of course, all wholesalers should be treated alike or their price differences should be justified. Even where the same customer is both a wholesaler and a retailer, there appears to be no objection to separate pricing of what he buys, i.e. charging him the same prices as other wholesalers on his wholesale business and the same price as other retailers on his retail business. The reasoning here is that he cannot thus suffer injury in competition with other buyers in the respective lines of trade.

To summarize, therefore, the cost problem consists of comparing the differences between prices, where there may be injury to competition, with particular costs named in the Act. A little later we shall consider how to find those differences.

How the Problem Arises

The comparison of cost differences with price differences is stimulated in a number of ways. For example, a seller may wish to prepare a new price list, or revise an old one, giving proper weight to cost differences. Or he may want to know how far off list he may safely go to secure a favorable contract. He may reasonably hope that, in the event a controversy later arises, the cost studies which he made in good faith as a basis for setting prices will be given proper weight. Or again, an aggrieved competitor or customer may instigate a Commission inquiry, whereupon the seller may attempt to justify his price differences and so either forestall the issuance

of a complaint or confine its scope. In the event a complaint is issued, the respondent may offer cost data in defence. After receiving a Commission order, the respondent may offer a cost study as evidence of compliance. And finally, in defense against a private suit for damages, the seller may seek to prove that his prices were cost justified.

Investigations by the Commission

The burden of cost justification in each of these instances is on the seller. Sometimes the Commission will offer, in rebuttal to the respondent's case of justification, studies of its own based on data presented by the respondent. Rarely will the Commission accountants develop cost studies from field investigations of their own; they will ordinarily confine themselves to checking the respondent's figures, securing more data, and refiguring costs in their own way. They could hardly do otherwise. For one thing, the staff of the Commission's Division of Accounting is small, consisting altogether of sixteen persons who perform a variety of tasks in addition to examining claims of cost justification. These tasks include general economic investigations, compilation of data in merger cases, establishing evidence of price fixing and of sales below cost, compiling financial statistics of companies, etc. The greater portion of the Commission accountants' time, however, is devoted to litigation, including price discrimination cases, where they work in close cooperation with Commission attorneys. In this latter activity their work closely parallels that of the independent CPA.

An Opportunity for Service

An interesting assignment for the CPA in this field is to assist his client by encouraging voluntary compliance with the Robinson-Patman Act to reduce the hazard of price controversy. There are degrees of violation of this law just as of other business regulatory laws or, let us say, cases where violation is hard to establish and cases which are sitting ducks. It can be a source of great satisfaction for the accountant to help alter a pricing structure to the extent that it may not be selected for prosecution as the horrible example in its industry. The analysis may even reveal hidden profit possibilities, with benefits extending far beyond the initial stimulus for the study.

Elements of Price

To repeat and emphasize what was said before, the prices which are compared will be for products of like grade and quality, sold in commerce under conditions which indicate that competition may be adversely affected. The exact prices which are to be studied are not always apparent. They should take into account every allowance, discount, rebate, etc., by whatever name, affecting the financial consideration which passes from buyer to seller. The inspection of catalogues and price lists is only a beginning of the study which must include a review of all pertinent papers including invoices, contracts and credit memos. But even these documents may not disclose all of the elements of price. An examination of the seller's books may reveal accounts for payments to customers which affect price.

Volume and Customer Classification

Where prices differ according to the class of trade to which the buyers belong, or other factors such as the volume of their purchases, it is useful to analyze sales volume according to customer groups. Such analyses will serve as bases of comparison with corresponding analyses of the pertinent costs. It will facilitate cost justification if the classi-

fication of customers for pricing purposes is logical and reflects actual differences in market functions performed by the buyers, differences in the way the seller deals with them, or in the quantities they buy.

It may not be appropriate to group customers for pricing according to the aggregate volume of their purchases from all sources. Say, for example, customers in a trade are classified according to their annual buying capacity—those using over a million units securing the lowest price and those using less paying higher prices. In such a case it may be possible for individual customers to divide their purchases among several sources of supply without affecting their price classifications. Whatever defenses may be discovered for such pricing, cost justification is not likely to be one of them because a seller under study may sell only a small quantity to a big buyer, ship in small lots, and experience great difficulty in satisfying his demands, whereas the same seller may ship larger lots to smaller buyers with less effort. The pricing scheme, by favoring large buyers just because they are large, flies in the face of the very purpose we ascribed in the beginning to the antitrust acts, viz., to encourage competition.

Individual Orders or Shipments

The pricing systems most readily cost justified are those in which price depends only on the quantity, in an individual order or shipment, either of the item in question alone or of a combination including that item. One example of such simple pricing would be:

Size of shipment (Dozens)	Price per doz.
1,000	$1.00
500	2.00
100	4.00

Another example might be:

Shipment	Price per pound
Carloads	$1.00
Less than carload	1.50

Variations of this kind of pricing would be a scale based on the quantity ordered at one time rather than on the quantity shipped or the total value of an order for different items.

Retroactive and Non-Retroactive Plans

In addition to these transaction prices, the pricing method often provides for credits, adjustments, or periodical allowances based on a scale of percentages related to the aggregate volume of a customer's purchases. These are called "volume discounts." When the percentages apply only to the volume of purchases in each quantity bracket (like Federal surtaxes) the plan is termed *non-retroactive*. Where the volume level attained determines the rate applicable to all of a customer's purchases, not only those falling in the particular bracket but those in all lower brackets as well, the plan is called *retroactive*. The price differences which result from these volume discounts may present great difficulty. They have given rise to so many controversies that we should clarify them by illustration. A non-retroactive plan might be this:

Annual purchases	Refund
$	%
0-999	0
1,000-2,999	1
3,000-9,999	2
10,000 and more	3

Under the foregoing plan, annual refunds in selected brackets would be:

Annual purchases	Refund
$	$
2,000	10
4,000	40
12,000	220

A retroactive plan with these same rates of 1, 2 and 3% would produce the following refunds in the brackets assumed:

Annual purchases	Refund
$	$
2,000	20
4,000	80
12,000	360

It is evident that the higher rate of refund in the retroactive plan has a corresponding effect on the task of justifying the price differences.

Naturally, buyers who are offered volume discounts, especially under a retroactive plan, try to qualify for the higher brackets. Where they form groups in order to combine the volume of their purchases while at the same time securing all services such as ordering, shipping, and billing as if they were separate buyers, the price differences may exclude the possibility of cost justification. For a long time such buying groups have been under Federal Trade Commission attack.

Return on Capital Not a Cost

The words, "cost of manufacture, sale or delivery" in the cost proviso of Subsection 2(a), seem to include every sort of cost actually incurred. However, opinions may differ as to whether an item is a cost at all. For example, whereas some economists regard a fair return on capital invested as a cost, many accountants, including the Commission's accounting staff, think it is not a proper item of cost justification. A great deal has been said on both sides of this argument and much more, doubtless, will be said before we have the final answer.

Suppose, for instance, a maker of machine parts sells his products both to original equipment manufacturers and to jobbers who resell them for replacement purposes. He may ship in carloads to original equipment manufacturers right from the end of his own manufacturing line. He serves his jobbers in less than carload lots from his branch warehouses in which he maintains large stocks of numerous items. The inventory of finished parts which he maintains for jobbers is therefore proportionately much greater than that which he maintains for manufacturers of original equipment. And for that reason he may claim that the difference in interest on that investment is a cost which results from a different method of sale.

Customer's Own Costs Not Considered

The wording of the proviso appears to confine the costs to be considered to those of the seller and to exclude those costs which his customers incur. In other words what the buyer does with the goods he has acquired is his own business. However, especially in selling dual-function buyers, it is not always apparent whether a payment or allowance is in reimbursement of a buyer's costs, a price reduction, or a seller's direct cost of sale.

Cost Differences—Sales Quantities and Methods

Although none of the seller's costs are excluded from consideration by reason of their natural classification—materials, wages, depreciation, etc.—the differences in cost must be shown to result from either the quantity sold or the method of selling. This limitation—this "resulting from" clause—creates many difficulties for the accountant. It requires him to become familiar with all phases of the seller's organization and operations in order that he may divide

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the costs between those which result from different quantities or methods and those which do not. The differential costs, (those elements of cost which vary by reason of different quantities or methods), ordinarily constitute a small portion of the total costs incurred in manufacture, sale, and delivery.

Limiting the Study to Differential Costs

Cost justification does not require balanced or inclusive costs because it is directed to a special object—showing differences in costs which are caused in the specified ways. The costs which are not differentiated in this special way may be ignored with gain in time and clarity. Some examples will perhaps help us understand this proposition.

If the only difference in price is the premium for less-than-carload orders, it may be sufficient to compute the difference between carload and l.c.l. rates, and to add if necessary the difference in cost of handling the two sizes of order.

Where goods are produced for warehouse stock on production schedules constructed with reference to prospective aggregate sales to all customers, the costs of manufacture applicable to separate customers become indistinguishable and may be disregarded. But where production schedules are prepared on the basis of individual customer orders, there are often substantial differences in unit costs of production arising out of differences in quantities manufactured. For example, if the machine set-up cost is $50, then the set-up cost per unit is $1.00 for a production run of 50 units and 5 cents for a run of 1,000. In such cases the most important costs to be considered are likely to be those manufacturing costs resulting from the quantity produced which in turn result from the quantity sold.

Distribution Costs

Whether the goods are identified with particular customers before they are made or afterward, differences in costs of distribution, as distinguished from production, may be attributed to different quantities sold or different methods of selling. Analysis of the cost of selling, administration, warehousing, delivery, and advertising will disclose those which are incurred directly for certain products, territories, or classes of customers, and those which are incurred for more than one of them. Costs are *direct* if the amount spent may be readily assigned to one of these categories; otherwise they are *indirect*.

For example, if costs are to be separated between those applicable to merchandise produced under the seller's own brand and unbranded product, all of the cost of advertising the seller's brand should be assigned directly to that category. The cost of the company's institutional advertising should be spread over all products or disregarded entirely.

Other cases are not so simple. For example, where the seller who distributes through wholesalers engages in missionary work with retailers, the circumstances must be thoroughly understood before assigning the related costs. If the missionary effort is directed to building up total sales volume through all customers, the costs are indirect, i.e., applicable without reference to any particular class of trade. On the other hand, if particular retailers are identified with particular wholesalers the cost of the missionary work may be a direct cost of selling the wholesalers.

Unit Costs

Where costs are incurred for two or more product or customer classes, it

frequently becomes desirable to compute cost rates which can be applied to the number of units in portions of the mixed aggregate. Finding such cost rates is an example in division in which the divisor is the total number of units, the dividend the amount expended, and the quotient is the rate per unit. Such dividends are likely to be the aggregate costs of performing certain functions, and the divisors those available statistical units which are the most logical measures of differences in those costs.

Suppose, for example, (1) the cost of direct selling to chain and independent grocers, including salesmen's salaries, travel, entertainment, and related expenses amount to $50,000 in one year, and (2) the best available statistics are sales calls of which there were 1,000, then (3) the cost per call (the cost rate) of $50 could be applied to the total calls on chains and the total calls on independents to arrive at the allocation of the total $50,000 between the two customer classes. This rough calculation would require refinement if study indicated that salesmen usually spent more time calling on customers of one class than on those of the other, or that branch managers at relatively high salaries made all the calls on the chains.

Among the many types of units frequently used in allocating joint costs are orders, shipments, invoice items, shipping units, weight, bulk, floorspace, time, distance, and number of customers.

The comparison of groups of customers, costs, and prices and the computation of unit costs ordinarily require the use of averages. The group to be averaged should be homogeneous; that is to say, the average should apply to each element of the mixture or to most of them. For example, the comparison of the average size of shipment to a seller's largest customer with the average size of shipment to all his other 3,000 customers might be challenged if the latter group included many diverse elements.

The Character of R-P Cost Accounting

Cost accounting of the sort we are considering is, as we have shown, a selective and not an inclusive matter. In product cost analysis, on the other hand, where the object is to find profit according to commodity groups, all of the costs allocable to a particular product must be accounted for. For example, the expenditures for materials, direct labor, advertising, etc., identified with a product must be assigned to that product. However, such product costs might in a particular instance be incurred in proportionally equal amount for all customers buying that product and therefore be entirely outside the problem of cost justification.

Once a cost justification study is completed its conclusions need not be demonstrated again and again because those conclusions remain valid until the business organization and methods to which they relate have substantially changed. In this respect, cost justification studies differ completely from the kind of costing useful in financial accounting and reporting where cost systems produce periodic statements.

Summary

We have seen that Robinson-Patman accounting deals with certain aspects of price and certain aspects of cost. Perhaps it is fair to say that in the usual case most of a concern's prices and most of its costs lie outside the scope of a Robinson-Patman study. The approach

to such a study includes a consideration of trade practices, competition, functional classifications, and many other business factors.

Price differences, where pertinent, must be compared with those cost differences which the Act specifies. The correspondence of these differences need not be exact but the price differences should make only "due allowance" for the cost differences. If the price differences reasonably approximate the cost differences they should be considered as meeting the statutory test of making "only due allowance". Literally interpreted, the cost proviso seems to limit price differences to differences in cost and thus to provide for a uniform profit per unit. On the other hand, perhaps the words "due allowance" are flexible enough to include a reasonable profit on the cost difference.

There is probably no mathematical formula for measuring "due allowance". It is certainly not subject to slide-rule calculation. To be workable, therefore, it should be subject to reasonable tolerances. Perhaps for this reason the Commission has indicated a readiness to accept or overlook a failure to justify which is no greater than one percent of the higher price.

And now a final suggestion. As he works at these problems, the accountant will be constantly aware that he is dealing with a combination of legal and cost accounting ideas and techniques. Consequently, he will find it natural to cooperate closely with legal counsel.

Costing as a Measurement of Effort

Costs are considered as measuring effort, revenues as measuring accomplishment. Costs are traced carefully from the first acquisition of goods or services through various regroupings for the specific object of having available, at the time of sale of the product, information regarding relevant costs —that is, those costs related to a specific segment of revenue because they are technically or economically associated with a corresponding segment of product, or unit of time in which such product appears.

Ideally, all costs incurred should be viewed as ultimately clinging to definite items of goods sold or service rendered. If this conception could be effectively realized in practice, the net accomplishment of the enterprise could be measured in terms of units of output rather than of intervals of time. . . . But in the more typical situation the degree of continuity of activity obtaining tends to prevent the finding of a basis of affinity which will permit convincing assignments, of all classes of cost incurred, to particular operations, departments, and—finally—items of product. . . . Not all costs attach in a discernible manner, and this fact forces the accountant to fall back upon a time-period as the unit for associating certain expenses with certain revenues. Time periods are a convenience, a substitute, but the fundamental concept is unchanged. The ideal is to match costs incurred with the effects attributable to or significantly related to such costs.

from An Introduction To Corporate Accounting Standards *by Paton and Littleton, American Accounting Association, 1940.*

Current Developments in New York State Tax Legislation and Regulations

By Mortimer M. Kassell

This article summarizes the various changes in the New York Personal Income Tax and Franchise Tax Laws made by the 1956 and 1957 sessions of the New York Legislature.

For many years there have been introduced in the Legislature, and frequently enacted into law, various amendments to Article 16 of the Tax Law which imposes the personal income tax. These bills in general are designed on the one hand to provide relief in various cases and on the other hand to plug loopholes. The result of some ten or fifteen years of this kind of treatment has transformed an otherwise simple income tax law into a highly complicated technical tax statute. While it is not nearly as much of a "monster" as the Internal Revenue Code, in my opinion it is far more complicated than a low-rate state income tax law should be. The justification for highly technical provisions may exist in a tax structure where the rates range from 20% to 92% but these provisions, whether they are to afford relief or to increase revenue, are wholly unjustified where the tax rates range from 2% to 7%.

This preface is designed to express not only an aversion but also an apology for most of what follows, since it is necessarily a technical analysis of the various recent changes made in the State Tax Law in relation to the income and franchise taxes.

The principal amendments to the Personal Income Tax Law passed in 1956 were the so-called "humanizing amendments." These were generally patterned on similar provisions in the Internal Revenue Code but were not identical with them and are applicable to returns due April 15, 1957 and thereafter.

Additional Exemptions for Blind or Aged

The first of these amendments allows additional exemptions for the blind and

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This article has been adapted by the author from a paper presented by him at the April 2, 1957 technical meeting of the Society, held under the auspices of the Committee on New York State Taxation.

those over 65. Thus, a married couple is entitled to the $2500 exemption and to additional exemptions if either or both are blind or over 65. The additional exemption for a single person who is blind or over 65 is $400, and $800 if both blind and over 65. This exemption, however, must be reduced by the amount that his gross income exceeds $6000. Thus, if a single taxpayer is over 65 and blind and has a gross income of $6300, he is allowed an additional exemption of $500 ($800 minus $300—the amount by which his gross income exceeds $6000). If his gross income is $6800 or more, no such exemption is allowable.

If a taxpayer has a wife who is blind or over 65, the additional exemptions are also allowed for the wife. In such case, the total of the additional exemptions of both must be reduced by the amount that their combined gross income exceeds $6000. For example, if a taxpayer is blind and over 65 and has a wife who is blind and over 65 and their combined gross income is $6700, additional exemptions of $900 are allowed ($1600 minus $700). If their combined gross income is $7600 or more, no such exemptions are allowable. The additional exemptions for the wife are allowed whether or not she has separate income. However, even if the husband and wife file separate returns, the additional exemptions must be reduced by their combined gross income and may then be claimed entirely by either or divided between them.

Proration of Additional Exemptions

Section 362 of the Tax Law, which provides for these additional exemptions, is patterned to some extent on section 151 of the Internal Revenue Code of 1954. Accordingly, the definition of blindness is identical both for New York and Federal income tax purposes. However, the Internal Revenue Code does not require the reduction of the exemption on the basis of gross income. Accordingly, the fact that a taxpayer who is blind or over 65 is entitled to an additional exemption for Federal income tax purposes does not necessarily mean that he is entitled to an additional exemption for New York income tax purposes. Furthermore, the right to exemption under Federal law is determined on the basis of the taxpayer's status at the close of the taxable year. Therefore, if a taxpayer is blind or over 65 at the close of his taxable year he is entitled to the full additional exemption under Federal law. However, under New York law if he is over 65 or blind for only part of the year the additional exemptions must be prorated. Article 209 of the Personal Income Tax Regulations sets forth the method of proration. A new Article 208-a was added to the Regulations explaining these exemptions. Under said regulation, as under the Federal regulations, a blind taxpayer must support his claim for the additional exemption by a certificate from a physician or registered optometrist.

Expenses for Care of Dependents

The second of the "humanizing" amendments was the allowance of a deduction for expenses incurred for the care of dependents. This deduction is generally referred to as the "child care" deduction, although it is not limited to expenses incurred for the care of a child but includes expenses for the care of any dependent who is physically or mentally incapable of caring for himself. This amendment was also patterned after the Federal deduction contained in section 214 of the Internal Revenue Code of

1954. Both the Federal and State law allow the deduction if incurred by a taxpayer who is a woman or widower, if incurred for a dependent's care while the taxpayer is gainfully employed or in search of gainful employment and if incurred to enable the taxpayer to be so employed. Both include in the definition of "widower" a man who is legally separated or who is divorced and has not remarried. Both prohibit the deduction for amounts paid to a dependent of a taxpayer. Both limit the deduction to married women only if they file joint returns with their husbands, unless legally separated.

The computation of the deduction under the two laws, however, is different. Under New York law, the amount of the deduction is $400 per dependent, with a maximum of $800, which must be reduced by the amount by which the gross income exceeds $6000, so that no deduction is allowable if the gross income is $6800 or more. The Federal law allows a maximum deduction of $600, which must be reduced in the case of a working wife by the amount by which the adjusted gross income of husband and wife exceeds $4500. Thus, no deduction is allowed for a married couple with a combined adjusted gross income of $5100. The reduction is not required under Federal law with respect to a single woman, a widower or a married woman whose husband is incapable of self-support by reason of mental or physical disability. This comparison of the two laws illustrates that the same considerations determine whether a person is entitled to the deduction but the amount thereof is computed differently.

Article 203 was added to the Personal Income Tax Regulations to explain this deduction in detail. This regulation is patterned after the Federal regulation dealing with this subject but is not as comprehensive. In view of the similarity between the two laws with respect to qualification for the deduction, the provisions of the Federal regulation will undoubtedly be considered even though not set forth in detail in the New York regulations.

Medical Expenses

The third "humanizing" amendment was the liberalization of the deduction for medical expenses. The principal change is in the amount of the deduction. Previously, the deduction was allowed for expenses in excess of 5% of net income, with a maximum of $1500 for a married couple or head of a household and $750 for others. Under the amendment, a deduction is allowed for the excess of medical expenses over 3% of the first $6000 of net income plus 5% of net income over $6000, and the maximum deduction for a married couple filing a joint return or head of a household was increased to $2500 and to $1250 for others. In addition, total medical expenses within the maximum limitation are allowed if the taxpayer or his spouse is over 65 or blind.

Although there is some similarity between the medical deduction for New York and Federal income tax purposes, the computation of the latter will not be particularly helpful for New York purposes. Under Federal law, medical expenses in excess of 3% of adjusted gross income are allowable, with a maximum deduction of $2500 per exemption and an overall maximum of $5000 on an individual return and $10,000 on a joint return. In addition, the cost of drugs is included in medical expenses for New York purposes but is only included for

Federal purposes if it is in excess of 1% of adjusted gross income.

This amendment to the Tax Law merely required an amendment to section 202 of the Personal Income Tax Regulations with respect to the amount of the deduction. The remaining provisions thereof continue to be applicable.

Alimony Payments

In addition to the "humanizing" amendments, various changes were made by the 1956 Session conforming the New York Personal Income Tax Law to the Internal Revenue Code. These changes are generally designed to simplify the preparation of returns by providing similar treatment of various items under New York and Federal law.

Subdivision 8 of section 359 was amended to provide that periodic payments made under a written separation agreement, as well as those made under a decree of divorce or separation, are taxable to the wife and deductible by the husband. This provision is similar to section 71 of the Internal Revenue Code, with one exception. Under the latter, this treatment applies only to payments under separation agreements executed after the enactment thereof, whereas the New York law is applicable to payments under all separation agreements whether executed before or after the amendment.

The 52-53 Week Fiscal Year

Subdivision 4 of section 350 was amended to allow taxpayers the option of filing personal income and unincorporated business tax returns on a 52-53 week basis if their books are so kept, and section 370 was amended to provide for the filing of returns in the case of a transition to a 52-53 week taxable year. These amendments conform to the provisions of section 441 of the Internal Revenue Code.

Basis of Property Includible in Estate

Subdivision 6 of section 353 was amended to establish the same basis for property transferred prior to a decedent's death, which is required to be included in his estate for estate tax purposes, as property acquired by bequest. For example, the basis of jointly owned property, gifts in contemplation of death and *inter vivos* trusts which are includible in the decedent's gross estate is their fair market value at the date of death. This amendment conforms to section 1014 of the Internal Revenue Code.

Sale of Personal Residence

Subdivision 1 of section 354-a was amended to permit the deduction of selling and "fix-up" expenses in determining the amount of gain on the sale of a personal residence which is taxable. This amendment conforms section 354-a with section 1034 of the Internal Revenue Code. At this point, it should be pointed out that by Chapter 209 of the Laws of 1957, the New York law has also been conformed to the Federal so that under both laws the new residence must be purchased or constructed within one year of the sale of the first residence. The new time limitation also applies to returns for taxable years commencing on or after January 1, 1956.

Death Benefit Exclusion

Paragraph 2 of section 359 was amended to limit the amount of employee death benefits excludible from gross income to a total of $5,000 rather than $5,000 from each employer, and to allow such exclusion with respect to

lump-sum distributions from a qualified profit-sharing, pension or annuity plan. This conforms to section 101 of the Internal Revenue Code.

Interest on Loans—Single Premium Contracts

Subdivision 2 of section 360 was amended to conform to section 264 of the Internal Revenue Code by prohibiting a deduction for interest paid or accrued with respect to money borrowed to purchase a single premium life insurance endowment or annuity contract.

Embezzlement Losses—Year of Deduction

Subdivision 6 of section 360 was amended to conform to section 165 of the Internal Revenue Code to provide that a loss from embezzlement or theft shall be deductible in the year in which the taxpayer discovers the loss, rather than the year in which the loss occurred.

Military Personnel

Amendments were made to various sections of the Tax Law providing similar treatment as the Internal Revenue Code with respect to the taxation of military pay and to returns and payments of military personnel. Although these amendments are rather extensive, the net effect thereof is that the same treatment is accorded to taxpayers in the military service as to all other taxpayers, since the relief provisions are applicable only with respect to military personnel serving in a combat zone and there is at present no such combat zone.

Applications for Revision

In addition to the foregoing, several miscellaneous amendments were made to the Personal Income Tax Law.

Section 374 was amended to limit the time for filing applications for revision to two years from the time the tax was paid or the return filed, whichever is earlier. This amendment was designed to prevent taxpayers from extending their time to file applications for revision by failing to file their returns even though their tax had already been paid. It is principally applicable to nonresidents whose taxes are paid by withholding agents.

Unlimited Charitable Deduction

Subdivision 14 of section 360 was amended to permit an unlimited charitable deduction if a taxpayer's contributions in the taxable year and the five (rather than ten) preceding years equal 90% of his net income.

Nonresident Withholdings

Subdivision 1 of section 366 was amended to exempt from the withholding requirements, amounts paid to nonresident beneficiaries by stock bonus, pension or profit-sharing trusts. This amendment was designed to encourage the use of New York trust companies for such purposes.

Information Returns on Wages Under $1,000

Subdivision 2 of section 366 was also amended to permit the Tax Commission to require information returns with respect to wages paid to employees (even if less than $1,000) if withholding is required pursuant to the provisions of the Internal Revenue Code. However, no action has yet been taken by the State Tax Commission and information reports are, therefore, only required with respect to wages in excess of $1,000.

Personal Income Tax Regulations

The foregoing briefly summarizes the amendments made to the Personal Income Tax Law in 1956. The Personal Income Tax Regulations were recently amended to reflect these changes. Al-

though in the past the Regulations have often been amended to reflect rulings of the State Tax Commission or changes in policy, the 1956 amendments are principally limited to incorporating the foregoing changes in the law.

Penalties Under Articles 9 and 9A

The 1956 Legislature made comparatively few changes in the franchise taxes imposed by Articles 9 and 9-A.

The principal change to Articles 9 and 9-A related to the imposition of penalties. One hundred per cent penalties were provided for the filing of fraudulent returns, as under Articles 16 and 16-A. In addition, penalties are imposed with respect to additional taxes resulting from Federal changes in the event of failure to file the required report of such changes. The penalties commence 30 days after the due date of such report.

Taxation of Omnibus Companies

The principal change to Article 9 related to the taxation of omnibus companies under section 186-a. A quarterly exemption was provided for $125,000 of receipts from omnibus transportation.

Returns in Whole Dollar Amounts

One general amendment enacted in 1956 authorizes the State Tax Commission to adopt regulations permitting taxpayers an option to file returns in whole dollar amounts instead of in cents, and to permit assessments of tax and refunds on the same basis. Such regulations were adopted for purposes of Articles 9-A, 16 and 16-A.

Percentage Reduction of Tax

During the legislative session which has recently terminated, almost one hundred and fifty amendments to the Personal Income and Franchise Tax Laws were proposed in the Legislature. The great bulk of these amendments are designed to incorporate into New York law various relief provisions contained in the Internal Revenue Code or to give special benefits not presently allowed under Federal law. Only a handful of these bills has been enacted.

The income tax reduction bill was enacted early this year in order to avoid the confusion which occurred last year. The same reduction applies to taxes for the year 1956 as for the year 1955, i.e., 15% of the first $100 of tax and 10% of the next $200 of tax. Chapter 207 of the Laws of 1957 provides the same method of reduction for purposes of the unincorporated business tax. The Governor apparently signed the bill with some misgivings, since in a message approving the bill he pointed out that an administration bill would have eliminated the tax entirely for some 35,000 small businesses and would have afforded relief up to $100 for many more.

Resident Credit

A resident credit was also enacted for the first time in New York State, thus protecting New York residents from double taxation. It allows a credit to a New York resident against his New York income taxes for the year 1956 for income taxes paid to another state on income derived in such state if the latter state does not allow a nonresident credit to New York residents. The credit is equal to the proportion that the taxpayer's income subject to tax in the other state bears to his entire income subject to tax in New York but may not exceed the amount of tax payable to the other state. In addition, the credit is not allowable if it results in a New York tax less than would have been payable if the income from the other state had been excluded in computing net income. The credit is limited to

one year, since it was enacted primarily to counteract the effect of the imposition of a tax on nonresidents by Massachusetts and it is hoped that Massachusetts will enact a nonresident credit in the coming year.

Reporting Partner's Income in Year of Liquidation

Chapter 372 of the Laws of 1957 partially conforms to the Internal Revenue Code with respect to the reporting of a partner's income. This amendment to section 364 of the Tax Law changes the taxable year in which a partner is required to report his distributive share in case his entire interest in a partnership is sold, exchanged or liquidated. Under present provisions of law, if a taxpayer has a different taxable year from the partnership he must report his distributive share in the taxable year which embraces the close of the partnership's taxable year. Under the amendment his distributive share would be reported in the taxable year in which the sale occurred, thus eliminating any delay in reporting. This change is a purely technical one and was recommended by the State Tax Commission.

Other Amendments

In addition, the following amendments were adopted:

1. A bill increasing the exemption from $400 to $800 for a dependent over the age of 18 who is in full-time attendance at an approved school or college. (Chapter 724)

2. A bill amending section 359 to conform to section 107 of the Internal Revenue Code, to exclude from gross income the rental allowance paid to a clergyman, as well as the rental value of a house furnished to him. (Chapter 408)

Complexity of Tax Law

A review of current developments in State taxation can easily evoke the fear that the law will be increasingly technical if the present tendency toward conformity with the Federal law continues. The only encouraging sign I can see is that if the New York law continues to become increasingly complex, taxpayers and their representatives will join with professional societies and others in an effort to simplify the entire New York income tax by adopting Federal net income as the base. In my opinion, such a revision is long overdue and I am hopeful that this millenium may yet be achieved.

Accounting System for a Small Water Plant

By Stanley L. Cohen, C.P.A.

This is a case study based upon personal experiences and observations of the author. The article suggests the need for utilization of non-accounting information and for simplicity in approach, in the development of an accounting system and auditing guides for a small, privately owned water plant.

For the past several years the housing and related industries have accounted for a substantial amount of this country's gross national product. The custom builder has been overshadowed by the large scale developer. While projects the size of Levittown are not too numerous, there are many subdivisions encompassing 1,000 to 1,500 single-unit residences. In some of these areas, the builder or land developer must provide his own utility plants for water and/or sewage treatment. The accountant, as an adjunct of his services related to construction, may find himself confronted with the problems of designing, installing and maintaining an accounting system for water and sewage treatment plants. This article will deal only with a water plant as it is the more extensive of the two.

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Technical Background

Before undertaking the design of an accounting system for a small privately owned water plant*, the writer deemed it necessary to acquire a working knowledge of the various elements of water production. The information presented in the following paragraphs was obtained from the supervising engineer.

A turbine type pump extracts the raw water from subterranean sources and forces it upward to an aerator. The aerator consists of four large trays, each containing coke. The frame and trays are constructed with tide-water cypress which is non-corrosive. The cascading water, flowing through the coke trays, has its iron removed by oxidation. The carbon dioxide in the raw water is dissipated by the air.

* Capacity—10,000,000 gallons per month.

From the aerator the water falls into an accelator. This device is a giant mixer and strainer. It is here that hydrated lime, aluminum sulphate, polyphosphate and other chemicals are added. The balance of the objectionable materials in the water is removed by the coagulating action of the additives. The resultant solid matter, called sludge, is removed to a sludge bed where it is ultimately disposed of.

The finished water rises to the top of the accelator and is conducted by piping to filters where it passes, by gravity, through six grades of anthracite coal. The water is drawn from the bottom of the filters and piped into the clearwell or underground storage tank. It is here that chlorine is added which constitutes the last purification process. The clearwell, together with other water storage components, serve to regulate the water pressure in the distribution system.

High-head service pumps force the water through the transite supply mains into the galvanized service pipe lines. From the service lines the water flows through meters into the respective houses.

Personnel Considerations

Since this plant was constructed to function with limited personnel, the water works employees merely load the automatic chemical feeders, read and service meters and maintain the plant equipment. The superintendent must also make chemical analysis of the water and report his findings to the State Board of Health.

The author also visited a nearby municipally owned water district serving approximately 1,200 customers. That organization consisted of three office clerks, five meter readers and maintenance men, and a general manager—head bookkeeper. All meters were read and customers' bills mailed during the first week of each month. Further, this district purchased water at wholesale rates from a neighboring town having no plant facilities of its own. Profit and loss statements prepared by the general manager disclosed a break-even situation. It was significantly noted that the employees had little to do the remaining three weeks of the month.

Accounting Functions

Based upon the orientation outlined above, it was decided to divide the accounting functions into the categories listed below:

1. Controls applicable to construction costs.
2. Determination of estimated revenues and expenses.
3. Design and installation of an accounting system.
4. Formulation of an audit program.
5. Preparation and analysis of financial statements.

Controls Applicable to Construction Costs

The construction of the water plant and distribution system was one of several simultaneous building projects including houses, a sewage treatment system and a shopping center. Therefore, a multiple subsidiary cost ledger was utilized having distinct sections for each of the projects. On the books of original entry of the general contractor all costs were separated into project columns. The individual items within each column were posted to the appropriate subsidiary cost ledger. The end-of-month total was posted to a general

ledger control account. Cost ledger schedules were prepared monthly and verified against the respective control account.

In the water system section of the cost ledger the following accounts were opened:

1. Concrete and block work.
   (a) Clearwell; (b) Office and storage buildings; (c) Aerator; (d) Sludge beds.
2. Accelator.
3. Chemical equipment.
4. Electrical equipment.
5. Water storage tanks.
   (a) Steel; (b) Erection costs.
6. Pumps and piping.
7. Engineering.
8. Distribution system.
   (a) 8 inch pipe; (b) 6 inch pipe;
   (c) 3 inch pipe; (d) 2 inch pipe;
   (e) Hydrants, valves and fittings;
   (f) Meters and meter boxes.
9. Force account expense.
   (a) Freight; (b) Repairs; (c) Analytical costs.
10. Other building costs.
    (a) Interior; (b) Exterior.
11. Miscellaneous costs.

Additional accounts were set up in the general ledger for such items as labor, payroll taxes, compensation insurance, etc. Administrative and other expenses were capitalized to water plant construction on a percentage-of-total-cost basis.

Memorandums of cost estimates were recorded in each ledger account and frequently compared with actual expenditures.

Determination of Estimated Revenues and Expenses

The supervising engineer furnished the writer with details of water consumption per family unit resident in the same general locale. Similar statistics were available from state and local agencies. The engineer was also able to supply chemical, electricity and maintenance costs. Utilizing the accounting system detailed below, payroll expense was calculated. The rates per thousand gallons of metered water were fixed pursuant to the posted table of an adjacent city.

A statement of projected revenues and expenses, on an annual basis, was prepared as follows:

Revenues		
1,100 customers @ $38 (based upon a family unit consumption of 84,000 gallons annually)		$42,000
Expenses		
Chemicals (@ $.037 per M gallons)	$3,400	
Electricity (@ $.033 per M gallons)	3,100	
Plant superintendent	5,200	
Clerk (salary allocated to water plant)	1,300	
Stationery and telephone	1,000	
Insurance, payroll taxes and miscellaneous	2,000	
Other maintenance costs	1,000	17,000
Net Income Before Depreciation		$25,000

Design and Installation of an Accounting System

Inquiries were made to determine the existence of governmental financial reporting and record-keeping regulations apart from those promulgated by taxing authorities. The responses received were unanimously negative.

The inefficiency in employee utilization, noted in the previously described

visit to the neighboring, municipally owned water system, accentuated the need for cycle billing instead of first-of-the-month billing. This was discussed with the client who accepted the logic of this recommendation.

The owners submitted a subdivision plat (project plan) of the area to be serviced indicating 1,100 potential customers. Upon installation of a meter, the serial number was entered on each plot. This afforded a measure of internal control over the number of customers as the subdivision was being developed in sections.

Since there are approximately twenty business days each month, it was decided to have fifty customers in any one cycle. Under the direction of the engineer, fifty contiguous plots were marked with a three-part account number as, for example, 3-14-7. The first digit represents the cycle billing date—third business day of the month. The second and third digits indicate the block and lot numbers respectively appearing on the subdivision plat.

The next fifty customers were similarly set up for an adjoining area. This was done so that the individual reading these meters, without losing time, could deliver the bills covering the previous day's readings.

The daily reading of fifty meters and the delivery of fifty bills left ample time for the single meter reader for plant maintenance, turn-ons and turn-offs and meter servicing.

One office clerk-bookkeeper was engaged. The preparation of fifty bills daily made for an even work load with sufficient time remaining to handle receipts, disbursements and the general books of account along with telephone calls, filing and numerous other clerical activities.

Design of Forms

Detailed cash receipts, sales and accounts receivable ledgers were eliminated and, in lieu of such extensive records, the following forms were used.

Form 1—Customer's Permanent File. The inside flap of this folder (an illustration of which appears as Figure I on page 406) was completed at the time the meter was installed and service turned on. The files are maintained in account number sequence in Drawer B.

Form 2—Monthly Bill (in three parts). The bill (reproduced as Figure II on page 407) is prepared by the office clerk who obtains the data from the meter reading book. A separate reading book exists for each cycle billing date. Names and addresses can be typed or imprinted by a plate machine.

After all the bills are prepared for a particular day, the clerk takes off on adding machine tape the dollar value of the billings and the water consumed. Both these totals are recorded in a sales journal.

The three part snap-out carbon form (Form 2) is separated. Part 3 is delivered to the customer. This part is made of heavy stock and can be easily modified for post card mailing or window envelope mailing. In order to preserve clear copies the heavy stock was used for Part 3. Parts 1 and 2 are placed in Drawer A behind monthly and billing date dividers.

Billing and Collection Procedures

When a customer remits payment, either directly or by mail, Parts 1 and 2 are removed from Drawer A. Part 1 is stamped paid, the date noted, and attached to the duplicate deposit slip

for such date. This, therefore, serves in place of a detailed cash receipts book. A daily summary of cash received is recorded in the appropriate book of original entry.

Part 2 is also stamped paid, the date noted, and filed in the applicable customer's file (Form 1). The bill represents the debit to the individual account receivable and the paid stamp denotes the related credit. Inquiries can expeditiously be attended to by reference to the customer's file which is located in Drawer B.

Any remaining bills in Drawer A constitute the accounts receivable. Moreover, in the event of partial payment, the bill is also retained in Drawer A, with appropriate notation. At the end of the month, an adding machine tape schedule is prepared and checked against the control account in the general ledger.

Standard Monthly Billing Not Practical

Consideration was also given to standard monthly billing based upon an average water consumption per family unit. However, this billing method was discarded as impractical for various reasons, several of which appear below:

1. To take advantage of the minimum rate it was necessary to bill monthly.

2. During the course of a year, prolonged dry spells resulted in above-normal consumption. It was deemed more advisable to maintain collections on a current basis as opposed to making large year-end adjustments.

3. In order to compare production with consumption, meters had to be read monthly. Should a major leak occur, the management would know by the end of the month that such a condition existed. The danger in wait-

Figure I

FORM 1—CUSTOMER'S PERMANENT FILE

Account No. ....

Customer Name ....

Customer Address ....

Block..........................Lot....................................

Meter No...............................Account No...............................

Deposit $........................Date Rec'd...

ing for a year-end reading is most apparent.

4. Using the system suggested in this article, which provided for a single meter reader, payroll expenses could not in any event be reduced. This, of course, would not be the case where several meter readers might be employed.

General Ledger Accounts

The general ledger follows the Uniform System of Accounts for Water Utilities, Classes A and B, as issued by the National Association of Railroad and Utilities Commissioners and published by the State Law Reporting Company of New York City.

Formulation of an Audit Program

In addition to the standard monthly audit procedures, with which all CPAs are familiar, the following items were appended to the audit program:

1. Compare schedule of water consumed with water produced.
   - a. Check master meter on control panel.
   - b. Check gallonage produced as indicated on monthly report to the State Board of Health.
2. Test check customers' bills.
   - a. As to meter readings (with meter reading books).
   - b. As to dollar charge (consumption with rate table).
3. Verify continuity of bills (*previous* reading on current month's bill with *present* reading on previous month's bill).
4. Check number of bills mailed out for the month with number of installed meters as per subdivision plat.

Figure II

FORM 2—MONTHLY BILL
(in 3 parts)

RETURN TO

Park Water Company
100 Main Street
Any City, Ohio

ACC. NO. ....

	For Service to
	Pres. Read
	Prev. Read
	Consumed
$	Amt. Water
$	Prev. Bal
$	Other
$	Total Due

STUB

ACC. NO..........

AMT. ....

Preparation and Analysis of Financial Statements

The balance sheet submitted to the management contained the following captions in accordance with the uniform system of accounting for water utilities.

ASSETS

1. Utility Plant and Equipment.
   a. Water Plant.
   b. Transportation equipment.
2. Currents Assets.
   a. Cash.
   b. Accounts receivable.
   c. Prepaid expenses and inventory of chemicals and supplies.

LIABILITIES

1. Capital.
2. Long-term Debt.
3. Current Liabilities.
   a. Accounts payable.
   b. Customers' deposits.
   c. Payroll taxes payable.
   d. Income taxes payable.
   e. Interest and other accrued expenses.
4. Reserves.
   a. Reserve for depreciation.
   b. Reserve for uncollectible accounts.
5. Surplus.
   a. Earned.

The Statement of Income listed the items appearing below:

OPERATING REVENUES

1. Metered sales to general customers.
2. Interdepartmental sales (water consumed for the other construction projects).
3. Customers' forfeited deposits.
4. Miscellaneous water revenues (penalties for turn-ons and turn-offs due to non-payment of bills, etc.).
5. Contract work.

SOURCE OF SUPPLY EXPENSE

1. Water purchased for resale (prior to completion of the plant).

POWER AND PUMPING EXPENSE

1. Electricity for power and pumping.
2. Supplies and maintenance.

PURIFICATION EXPENSE

1. Purification supplies.
2. Maintenance of purification equipment.

TRANSMISSION AND DISTRIBUTION EXPENSE

1. Meter maintenance.
2. Maintenance of mains, hydrants and plant.

CUSTOMERS' ACCOUNTING AND COLLECTING EXPENSES

1. Meter reading.
2. Billing and accounting.
3. Uncollectible accounts.

ADMINISTRATIVE AND GENERAL EXPENSE

1. General office supplies.
2. Telephone.
3. Insurance.
4. Legal and accounting.

Expenses sustained were in substantial agreement with original estimates.

An analysis of water production by months revealed significant fluctuations. This situation is generally caused by the absence or presence of natural precipitation. An abnormally dry period results in high consumption. While this is ideal in increasing revenues, there is a comparably greater work-load on the equipment with attendant consequences.

If nature does not afford adequate explanation for such discrepancies, then other possibilities must be pursued. Children turning on hydrants, broken mains and, on occasion, dishonest customers who expend the money and effort to "jump" their meter, represent sources of displeasure to the auditor attempting to reconcile production with sales.

By being constantly alert to metered gallonage, management is able to resolve these problems:

1. Is the plant operating efficiently?

2. Are the leaks in the distribution system either fortuitous or malicious?

3. Is the plant equipment being subjected to excessive wear-and-tear which might warrant premature replacement?

4. Are there sufficient chemicals on hand to insure uninterrupted operation?

5. Is proper pressure being maintained so as to provide maximum flow at the customer's water outlet? (Low pressure results in low consumption and relatively small billings.)

Conclusion

The accounting system discussed in the preceding pages has been satisfactorily functioning for the past eighteen months with little modification.

It is the author's belief that CPAs have a professional obligation to devise systems requiring the minimum of record-keeping consonant with sound accounting and auditing principles. This can only be accomplished by a thorough and comprehensive knowledge of the business enterprise. Each installation presents a challenge to the practitioner which should be met with imagination and conviction which, when allied with good judgment, constitute the elements of successful professional service.

Characteristics of Appropriate Records and Forms

It [i.e. the form or record] must serve a useful function in its relation to the procedures designed to accomplish the objectives of management.

It must be sufficiently simple so that it may be clearly understood by those who are to use it, enabling them to record data promptly, accurately, and at a minimum of cost.

It should be designed in the light of all its possible uses so that the number of different forms may be held to a practicable minimum.

It should be so constructed that proper handling would necessitate adherence to the control procedures set up, thereby providing a degree of internal check within the form or record. In the case of forms, blanks for authorizations and approvals relating to the various steps of the transactions, the alignment of the data to facilitate arithmetical check, and proper routing instructions are all examples of control which may be provided by proper designing.

from INTERNAL CONTROL—ELEMENTS OF A COORDINATED SYSTEM, *American Institute of Accountants, 1949.*

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

Additional Exemption for Taxpayers Who Reach Age 65 . . . Taxable Year of Partners . . . Liability for Franchise Tax . . . Definition of a Real Estate Corporation.

Additional Exemption for Taxpayers Who Reach Age 65

Like the Federal law, New York allows an additional exemption to a taxpayer who reaches the age of 65. This exemption is $400 and first became applicable to a taxpayer who was 65 years of age or over in 1956.

Unlike the Federal law the additional exemption depends upon gross income. The additional exemption of $400 must be reduced by the amount by which the gross income of the taxpayer, or the aggregate gross income of husband and wife living together, exceeds $6,000. The Regulations define gross income as income in the broad sense less income which is excluded from tax. On Form IT-201 that would mean total income shown on line 30, before deductions. A gross taxable income of $6,400 would eliminate entirely this additional exemption of $400.

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Mr. Harrow is a past Vice-President of the Society. He is a member of the Society's Committees on Meetings and Committee Operations, and had served for a number of years on the Institute's Committee on Federal Taxation.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

Taxable Year of Partners

A partner is taxed upon his distributive share of the profits of a partnership for the latter's fiscal or calendar year ending within the partner's fiscal or calendar year. Until the law was changed* by the 1957 legislature, even the sale or liquidation of a partnership interest during a partnership fiscal year did not change the time for reporting any income. For example, suppose a partnership had a fiscal year ending June 30, 1956. A partner on a calendar year basis would report his distributive share of income from the partnership for the period from July 1, 1955 to June 30, 1956 on his 1956 return. Suppose the partner sold his interest on October 15, 1956. His distributive share of partnership profits from July 1, 1956 to October 15, 1956 was taxable to him on his 1957 return.

* L. 1957 c. 375, eff. 7/1/57.

Beginning July 1, 1957, if a partner sells his entire interest in the partnership or if that interest is liquidated, then his distributive share of the net income of the partnership for the period ending with the sale or liquidation is reportable for the partner's taxable year in which such sale or liquidation occurred. In the illustration given above, that would mean reporting the distributive share on the 1956 return instead of the 1957 return. It should be noted that the law specifically provides that the death of a partner does not constitute a liquidation of his entire interest in the partnership.

Liability for Franchise Tax

Usually a corporation is organized to exist in perpetuity, but suppose a corporation is organized to last for twenty years. Is it subject to a franchise tax in the twenty-first year assuming that it has not been legally dissolved. The franchise tax is levied for the mere possession of the privilege of exercising its franchise whether or not it actually uses such privilege by doing business. Even though the legal life of the corporation may have ceased by the terms of its charter, if it continues to do business as a corporation it is at least a de facto corporation and taxable as such. A foreign corporation is taxable if it does business in New York whether or not it is qualified to do so.

If the corporation has distributed its assets and is no longer engaged in any activity it would probably not be subject to any franchise tax since by its very charter it is no longer a corporation de jure or de facto.

Definition of a Real Estate Corporation

A corporation that owns a leasehold of more than twenty-years duration and under the terms of the lease pays the real property taxes, qualifies as a real estate corporation.

Suppose this corporation (Corporation A) subleases the property to another corporation (Corporation B) for a similar term and the latter corporation pays the real estate taxes, does Corporation A lose its classification as a real estate corporation? This question was before the Tax Commission recently. The taxpayer argued that while Corporation A made a sublease to Corporation B, the main landlord had never released Corporation A from the real estate taxes. That obligation therefore could not be shifted to a sublessee. The fact that the sublessee agreed to pay the real estate taxes meant that the obligation was in substance only additional rent payable to the lessee. The payment of the real estate taxes by Corporation B was a payment of the taxes by Corporation A within the meaning and intent of the statute. The State Tax Commission accepted that reasoning and permitted Corporation A to continue its classification as a real estate company.

Accounting at the SEC

Conducted by LOUIS H. RAPPAPORT, C.P.A.

SEC Denies Exemption from Registration in Decision Involving Misleading Financial Statements and Inadequate Audit

Under the Securities Act of 1933 the SEC is empowered to exempt certain offerings of securities from the registration requirements of the Act when the amount of the public offering is less than a designated sum. Pursuant to this provision of the law, the SEC promulgated *Regulation A* relating to exempt offerings. Under the Commission's Rule 223, however, the SEC may order the permanent suspension of the exemption in a particular case when it finds that the offering circular (which must be given to persons to whom an offer is made) contains false or misleading statements.

In a recent decision* the SEC ordered the permanent suspension of the exemption, and based its decision, among other things, on the fact that the financial statements in the offering circular were false and misleading, and that the scope of audit made by the certifying accountant was inadequate. The facts in the case insofar as they are of interest to public accountants were as follows.

Coastal Finance Corporation, which was organized in 1949, was engaged in the consumer finance business. It prepared an offering circular, dated August 5, 1955, covering an offering of common stock under *Regulation A*. The SEC temporarily suspended the exemption with respect to Coastal's offering and held a hearing to determine whether the suspension should be vacated or made permanent.

Coastal operated twelve loan offices, each of which was organized as a wholly owned subsidiary, located in Maryland, Virginia, Florida, and Pittsburgh, Pennsylvania. The offering circular stated that Coastal was founded by Frank B. Bush who had been its President and General Manager since its inception. Bush and his wife jointly owned a majority of the Class B Common Stock, which had the right to elect a majority of the board of directors.

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* *In the matter of Coastal Finance Corporation*, Securities Act Release No. 3775, April 10, 1957.

Disclosures regarding write-offs, reserves for loans, income and assets. The offering circular stated that past-due loans considered by Coastal to be uncollectible were written off on or before June 30 and December 31 of each year and that charges were made against current income as provision for bad debts in such amounts as were believed by the management to be adequate. Following this statement was a table showing the provision for write-offs, actual write-offs and remaining reserves for the years 1949 through 1954 and the first six months of 1955. The offering circular also contained a summary of earnings and comparative consolidated balance sheets covering the same period. The SEC's suspension order alleged, with particular reference to the year 1954 and the six months ended June 30, 1955, that Coastal did not write off all past-due loans known to be uncollectible, that the charges against current income as a provision for bad debts and the reserves provided therefor were inadequate, that the summary of earnings reflected income figures greater than those actually realized, and that the comparative consolidated balance sheets reflected total assets at values greater than those actually in existence, resulting in an overstatement of earned surplus, total surplus, total net worth and total capital funds.

In the fall of 1954 Bush had discussions with an insurance company as a result of which Coastal obtained a loan of $300,000 in December, 1954. In connection with this financing program, Bush instituted an intensive drive for increasing income and reducing delinquency percentages. He established minimum goals which would require each office to obtain substantial increases in income and reductions in delinquencies. This program was discussed with John J. Conway, who had recently been promoted to vice-president, and Larkin E. Bullard and Bernard J. LaPorte, who acted in a supervisory capacity, as well as various office managers, and he sent memoranda to all offices urging the personnel to meet the high quotas.

Beginning in November, 1954 the reports from the branch offices of income collections and deficiencies showed substantial improvement. However, at the same time practices developed which had the effect of overstating income and concealing the time delinquency status of loan accounts. One of these practices was referred to in the testimony as "rolling an account." This involved the renewal of a delinquent loan when the credit factors did not justify a renewal and the application of the proceeds as an interest payment on the old account. The effect of this practice was to inflate the income figures. Most of the accounts so renewed were delinquent accounts which had been previously classified as uncollectible and charged off against profit and loss, and as to such accounts the practice was also referred to as "reactivating a P & L account."

Another irregular practice employed by the Coastal personnel was referred to as "spreading payments." This consisted of the allocation of fictitious payments to what would otherwise be delinquent loans for the purpose of taking or keeping such loans out of a delinquency status. The source of these fictitious payments was usually the proceeds of reactivated P & L or rolled accounts where not all of the proceeds of the new loan were credited to the old account. Although the spread payments were usually small in amount, they had a substantial effect on the records of delinquent loans because of Coastal's policy as to determining delinquency. For example, one category of

delinquent accounts (referred to as 90-day accounts) consisted of accounts on which no collection had been made for 90 days or more. Under Coastal's practice, if any payment was recorded on the account within the preceding 90 days, no matter how small the payment or how large the past-due interest and principal, that payment would take that account out of the 90-day delinquent category. Other categories of delinquency were handled similarly. The use of spread payments resulted in the reporting of lower delinquency percentages and contributed to the inflation of income figures.

These practices had a very substantial effect on the financial statements. On August 16, 1955, Mr. S, a member of the firm of O and Company, who had been auditors of Coastal for some time, in the course of a routine audit of one of Coastal's offices discovered evidence of improper renewals of charged-off loans and spread payments. He reported the situation to Bush the same day. Thereafter the auditors discovered evidence of the same practices in other offices and then made special audits of all the offices to discover the extent and effect of the improper practices. On the basis of these special audits, they prepared revised figures for the periods covered by the financial statements in the offering circular. The differences between the figures in the financial statements in the offering circular as of June 30, 1955 and for the six months then ended and the auditors' comparable adjusted figures were found to be as follows:

	Amounts in Offering Circular	Adjusted Amounts	Difference
Small loans receivable	$2,667,824	$2,597,965	$ 69,859
Reserve for losses	80,975	256,973	175,998
Surplus	199,267	(42,309)*	241,576
Gross operating income	407,827	351,897	55,930
Provision for losses charged against income	27,099	203,097	175,998
Operating income	107,695	(128,130)**	235,825

* Deficit.
** Loss.

The misleading nature of the financial statements in the offering circular was conceded. The extent of the concealment of the delinquency situation by the spreading of payments was indicated by the fact that reports submitted by Coastal's offices for September, 1955, after the issuance of instructions to show the actual number of delinquent loans without applying fictitious payments to hide delinquency, revealed that there were 1,960 delinquent accounts as compared with 803 delinquent accounts shown at the end of August, 1955, with substantial increases being reported by all offices.

As indicated above, one of the issues in the SEC proceeding was the accuracy of the statements in the offering circular that past-due loans considered by the Company to be uncollectible were written off and that the Company charged against current income as provision for bad debts such amounts as were believed necessary by the management. The only substantial controverted question in this phase of the case arose from the fact that, although the practice of rolling accounts and spreading payments was widespread throughout the Coastal organization during the period in question, Bush claimed that he knew nothing about it until August, 1955.

Bush was in complete charge of the management of Coastal. He conceived

and put into execution the drive starting in November, 1954 to increase income and reduce delinquency. In the memoranda to all Coastal offices mentioned above and the meetings with Conway and the supervisors and office managers, he strongly emphasized the necessity of showing results. Bush formulated projections of income requirements and delinquency quotas which Conway and the supervisors testified were impossible of attainment by normal procedures.

Conway, Bullard, and LaPorte, as well as an office manager, the assistant treasurer and the assistant secretary all testified that they knew of the irregular practices. Conway testified that he discussed spread payments with Bush early in 1955 in a general discussion of charge-offs and delinquencies. Bullard testified that in a discussion with Bush about the resignation of one of the office managers, he told Bush that in his opinion the real reason for the resignation was the large number of spread payments. The assistant secretary testified that she told Bush that she understood that managers were being required to reactivate P & L accounts.

Each of the loan offices sent to the home office daily reports which listed, among other things, the payments received, giving the names of the borrowers and the amounts paid on principal and interest. The totals on these reports were transferred to monthly progress charts. This work was done primarily by the assistant treasurer but many times Bush would pick up a number of daily reports and transfer the figures to his copy of the monthly progress charts. The assistant treasurer estimated that, including the reports which Bush picked up for examination and those which the assistant treasurer brought to Bush when he had some question about them, Bush saw about 25 per cent of the daily reports. The evidence showed that a person experienced in the small loan business, as Bush was, could readily determine from these reports that spread payments were being made. For example, one report showed that, of 67 accounts on which payments had been recorded, 27 showed payments in even dollar amounts, such as $1.00 on interest and $1.00 on principal. Another showed even dollar payments on 12 accounts out of 32. One daily report showed 9 payments of one cent each on principal; another showed 18 payments of fifty cents each on principal. Although in most of the reports which were introduced in evidence the indications of spreading payments were not so obvious, a review of any substantial number of them would clearly show the existence of irregular practices.

The monthly delinquency reports showed a spectacular reduction in delinquencies as a result of the drive to obtain a showing of better results. In September, 1954 the delinquent accounts numbered 623, or 8.16 per cent of the accounts outstanding. By June, 1955 the number of delinquent accounts had been reduced to 393, or 3.24 per cent of the accounts outstanding. In the light of the past experience of the company, the SEC said it should have been apparent that such a result could not have been obtained without resort to irregular practices. As noted above, in September, 1955, after orders were issued to discontinue the improper practices, the number of delinquent accounts rose to 1,960, which was 18.73 per cent of the accounts outstanding.

In addition, during the period of the improper practices the monthly reports from the Coastal offices indicated a ratio of interest collections to the amount of interest accrued which was substantially higher than previously

and should have been recognized as unexplainable on the basis of normal experience and procedures.

Bush had been in the small loan business for 28 years and had been the President and General Manager of Coastal since its organization. While he relieved himself of some of the detail of operations after the appointment of Conway as vice-president, he maintained a close supervision over and intimate connection with all the activities of Coastal. In view of the facts outlined above, the SEC held that his assertion that he did not know of the existence of the irregular practices until August, 1955 "cannot be accepted."

Dividends charged to capital surplus. The statements of consolidated surplus in the offering circular indicated that during the year 1954, $56,131 representing dividends paid on the Class A Common Stock was charged to capital surplus. The earned surplus at December 31, 1954 and June 30, 1955 amounted to $71,253 and $82,776, respectively. The SEC stated, "The charging of the dividends to capital surplus in these circumstances was without accounting support, making the financial statements materially misleading even though the charge was disclosed in a footnote to those statements."

Scope of audit. The suspension order alleged that the accountants' examination of the financial statements was not made in accordance with generally accepted auditing standards. The financial statements were certified by O and Company who were referred to in the offering circular as independent public accountants. They had been accountants for Coastal since its organization. Among other activities it conducted surprise audits of each of the Coastal offices at least once a year. During the year 1954 it conducted these audits between May 17 and December 15. However, in 1955 the firm did not begin its schedule of annual examinations until August 16. As stated above, it was on this occasion that Mr. S discovered the irregularities in the accounts.

The firm's certification of the financial statements covered statements for June 30, 1955 and the six months then ended. As indicated above, between January 1 and August 3, 1955, the date of the accountant's certificate, the firm made no field examination of any offices. During this period its work was limited to bookkeeping activities at the home office. Also, the office in Pittsburgh (acquired in February, 1955) had never been audited by the firm. In these circumstances, said the SEC, "the accountants were not in a position to apply an adequate independent judgment as to the management's decisions as to the provisions for losses as well as other important matters reflected in the financial statements." Accordingly, the SEC held, "the representation in the accountant's certificate, with respect to the June 30, 1955 financial statements, that their examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as were considered necessary was inaccurate and misleading."

In view of these and other deficiencies, the SEC suspended permanently the exemption from registration.

Administration of a CPA Practice

A forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Tax Season Autopsy . . . New State and Federal Unemployment Insurance Filing Requirements . . . Return Signed for Taxpayer by Spouse Is Complete . . . Accountants' Own Payroll and Clients' Cost Records . . . Staff Criticisms and Tenure.

Tax Season Autopsy

Before the trials and tribulations of the past personal income tax season are rendered vague and nebulous by the surge of spring, take a serious look at what happened to see wherein improvements can be made for utilization next year. Remember—before you realize it, the next season will descend upon you.

One approach is to ask for suggestions from staff men and office personnel, all who dealt with any aspect of the returns. If an incentive is desired, offer prizes for the top three suggestions.

Another approach is a post-mortem conference of selected personnel to discuss the difficulties that may have developed.

If one follows the practice of making a note of flaws and bottlenecks as they are recognized, these items can be studied in a period of peace and quiet.

New State and Federal Unemployment Insurance Filing Requirements

The minimum employment requirements have dropped to the level where hardly any employers are now exempt, except those still enjoying statutory immunity.

Therefore, to insure against oversights, accountants would be well advised to review all clients' records to single out those clients who have not filed unemployment insurance returns. These exceptions should be carefully reviewed to ascertain that no violations exist.

Obviously the newly qualified employers must register and obtain employers' numbers, and their payroll records must be reviewed as to compliance with departmental requirements.

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Return Signed for Taxpayer by Spouse Is Complete

The Fifth Circuit Court, in a recent decision, held that returns signed for the taxpayer by his wife (who filed no separate returns of her own) were complete returns, even though she held no power of attorney and her husband was not incapacitated or outside the United States. The returns were signed at her husband's instance in the presence of his accountant.

The court held that these returns were sufficient to start the running of the statute of limitations on assessment and collection of deficiencies and to prevent imposition of penalties for failure to file.

The court further held that the regulations providing for signing returns under a power of attorney cannot be construed as making a return that does not comply with its terms "no return at all."[1]

On remand to the Tax Court, the Commissioner withdrew his claim for delinquency penalties and conceded that the statute of limitations barred his assessment of deficiencies for the years for which no waiver had been filed.

The above decision may be extremely helpful, particularly in situations where it may be difficult to obtain the timely signature of one of the spouses in the case of a joint return.

Accountants' Own Payroll and Clients' Cost Records

A payroll analysis service is being offered to accountants having staffs of more than about 20 men which will quickly provide an analysis of each man's time for a specific period, and accumulate clients' cost records. A feature of this plan is that it overcomes the objection to punch cards referred to in the *C.P.A. Handbook,* (Chapter 7, p. 81), namely that the end tabulations do not show the nature of the work performed.

[1] *Miller* v. *Com.* (CA-5) 56-2, USTC Parag. 10,009.

Outline of the procedure:

Each week (or other payroll period), each man prepares a separate card for each engagement to which he devotes time. Similarly, he prepares a separate card for each classification of unbillable time. The identical card is used both for written information and for keypunched information. Certain areas on the card are reserved for writing and other areas for punching.

The man writes the code number of the client, the code for the type of service rendered, his own code number, and the time spent. He also notes any unusual or non-routine circumstances.

At the end of the week, he submits these cards together with a very brief summary sheet. The summary sheet is used to support the payroll. The cards are sent to the Service Bureau.

The Service Bureau punches the cards and prints a listing showing for each week how each man spent his time. Then, all cards for the month are sorted together and the report by client is prepared. There is a separate page for each engagement. It shows the names of the men who worked on it, the time spent, and when it was spent. If desired, it can also show billable and cost values. The report shows a distinctive symbol on the line for each card which indicates any unusual circumstances.

Each month, after running the reports, the Service Bureau arranges the cards in sequence according to client, and returns them to the accounting firm. Because each card provides space for noting "Nature of Work and Special Comments", the partner or manager can conveniently analyze the causes for any substantial deviations from budgeted time. Thus, he can equip himself with a factual foundation for any fee discussion with the client.

(Continued on page 421)

Payroll Tax Notes

Conducted by SAMUEL S. RESS

The Hughes-Ashberry Bill on Unemployment Insurance . . . Calculation of 1957 Unemployment Insurance Tax Rate . . . Subsidiary Contribution and Successor Company.

The Hughes-Ashberry Bill on Unemployment Insurance

The Governor vetoed the Hughes-Ashberry amendments to the unemployment insurance law which were designed to raise the maximum benefit rate to $45 a week, and to raise the maximum basic employer contribution rate from 2.7 percent to 3.2 percent in 1958 and to 3.5 percent in 1959. The subsidiary contribution with which accountants have become familiar for the first time this year with the imposition of the .3 percent tacked on to the employer's experience rate, was continued in the vetoed bill except for a change in the basis of computation. A special session of the legislature is to convene on June 10 to reconsider amendments to the unemployment insurance and workmen's compensation laws.

The Bill provided that whenever the balance in the general account drops below $100 million subsidiary contributions would become due. The subsidiary contribution rate would range from .2 percent to 1.0 percent. The method of charging and crediting the general account, and the provision for a new escrow account to permit the proration of negative balances in individual employer accounts over a four-year period, were other new devices written into the vetoed bill.

In his veto message, the Governor stated:

"By setting a new and unprecedented high unemployment insurance payroll tax in New York State, this bill would grant tax benefits to many large firms, at the same time that it would increase from 2.7 percent to 3.5 percent the tax that would have to be paid by thousands of employers and firms, most of them small, engaged in seasonal or non-regular types of activity. Among those hardest hit would be canning and food processing, construction, apparel manufacturing and certain resort hotels."

He also pointed out that last year the New York State Unemployment Insurance Fund paid out $213,700,000 to

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611,000 benefit claimants. He was also critical of the treatment given to "voluntary quits" who applied for benefits, the change in the proportion of benefits to earnings in the case of higher bracket benefit claimants, and the easing of the deposit requirement of employers who contest the claims of more than one benefit claimant in cases where a single issue is involved in all the claims such as industrial dispute, vacation shutdown, etc.

Calculation of 1957 Unemployment Insurance Tax Rate

Tax rates for different employers in the same line of business for the year 1957 range from .5% plus the .3% subsidiary tax to a maximum of 3.0% including the .3% subsidiary tax which all employers, except certain newly-covered employers, are required to pay for the first time this year.

The calculation of the correctness of the employer's tax rate for unemployment insurance can be determined by each accountant for his client. The factors that make up the rate are:

1. Age of the employer measured by the number of years of coverage since his subject date, including predecessors, if any, prior to 1956. From .5 to 2.0 points toward the experience factor can be computed on the basis of *age*. See section 581-1(j) of the Law.

2. The *quarterly factor* is determined by computing the percentage decrease in remuneration (all earnings including amounts in excess of $3,000, bonuses, etc.) paid from one quarter to the next, for each of the 12 calendar quarters from July 1, 1953 through June 30, 1956.

The sum of the quarterly decrease quotients (do not offset the quarterly increase quotients against the decreases) provides the basis for the determination of the quarterly factor which may range from 0 (zero) to 2 points toward the experience factor, according to the table in section 581-1(h) of the Law.

3. The *annual factor*, which provides from 0 (zero) to 2 experience factor points, can be determined by getting the sum of the annual decrease quotients in remuneration paid for each of the fiscal years ended June 30, 1954, 1955 and 1956. See table in section 581-1(i) of the Law.

For firms newly covered on or after October 1, 1953 and have had more than four quarters of coverage prior to the computation date, July 1, 1956, the sum of the quarterly and annual decrease quotients is obtained by applying a special equalization formula which will be discussed in a future issue.

4. The *benefit factor*, the most important element in the experience factor since it provides from 0 (zero) to 16 points, is obtained by adding to the July 1, 1955 balance in the employer account, the amount of contributions due and paid from July 1, 1955 through June 30, 1956, less the benefit payments charged as set forth in the Notices of Charges for period July 1, 1955 through June 30, 1956. The balance thus obtained in the employer's account on July 1, 1956 is then divided by the total payroll subject to tax for the calendar year 1955. The employer's account percentage is the basis for the number of points allowed according to the table set forth in section 581-1(g) of the Law.

The sum of the age, quarterly, annual, and benefit factors is called the experience factor. The number of points in the experience factor determines the employer's regular tax rate of .5% to 2.7% (as set forth in section 581-2) to which is added the .3% subsidiary tax rate. See section 581-2(a) of the Law.

Subsidiary Contribution and Successor Company

A member of the Society recently submitted the following inquiry:

"A client of mine operated as an individual proprietorship up to and including December 31, 1956. On January 1, 1957 a corporation succeeded to the operations. . . . Is there a liability for subsidiary contributions in this situation?"

The answer is yes. Section 577.5 of the unemployment insurance law relating to subsidiary contributions provides: ". . . If an employer has acquired in whole or in part an organization, trade or business of another employer, the period of liability of both employers shall be considered as that of the acquiring employer. . . ."

Administration of a CPA Practice

(Continued from page 418)

If the firm feels that such information can be entrusted to the Service Bureau without hazard, the reports will show the names of the clients and staff men in the alphabetic tabulations.

Accounting firms that are desirous of contacting the organization offering this service can obtain the name by requesting it from the Editor of this Department.

Staff Criticisms and Tenure

A recent article in *Advanced Management* ("Nobody Cares How Tough You Had It" by Allen Hewlett, September 1956 issue) should be of interest and value to accountants who are concerned with personnel relations.

A few quotations will bring out most effectively some of the highlights of this article. Though not prepared for accounting firms, it nevertheless has something to offer them.

"Most of us tend to regard anyone who criticizes conditions which we have taken for granted as being guilty of disloyalty. We think he is a sorehead. But progress comes only because of somebody's discontent with things as they are.

"There is evidence that the personality characteristics which dispose a man to expressions of criticism also are the very ones essential to competence.

"Regardless of the question of fairness, a policy of promotion from within can debilitate a company. As often happens, such a policy also becomes a policy of promotion on seniority. Then, indeed, there is inbreeding and degeneration for there is no place for new blood."

Federal Income Tax Notes

Conducted by Richard S. Helstein, C.P.A.

The *Automobile Club of Michigan* Decision . . . Time for Deduction of State Taxes . . . Penalties are Deficiencies in Tax . . . Interpretation of I.R.C. . . . Section 306 Stock . . . Legal and Executor Services Are Separable . . . Personal Service Contracts . . . Retirement Income of Professional Men . . . Payments to Former Stockholder . . . Year of Deductibility of Payment for Past Services . . . Insurance on Lives of Officer-Stockholders . . . Life Insurance Premiums are not Deductible as Alimony Payments.

The *Automobile Club of Michigan* Decision

In a long-awaited decision, the Supreme Court has upheld the Commissioner on three important points:

1.—In 1934 and 1938 the Commissioner had ruled the taxpayer a tax-exempt organization. In 1945 the Commissioner revoked the ruling retroactively and directed the taxpayer to file returns for 1943 and subsequent years.

The Court held that since the original ruling was an error of law, the Commissioner was not estopped from revoking it, and that under Sec. 3791 IRC 1939, he had it within his discretion to determine the retroactive extent of the revocation. Nor was the determined extent of retroactivity by the Commissioner an abuse of his discretion, since a uniform policy had been adopted in 1943 of denying exemption to automobile clubs.

2.—The taxpayer's claim that the statute of limitations barred the assessment of deficiencies for 1943 and 1944 was also denied.

Since no returns were filed, the statute did not begin to run from the date the returns would have been due, absent the exemption rulings. Further, information returns on form 990 do not start the running of the statute since they lack the data necessary to determine tax liability and hence are not tax returns.

3.—Membership dues, paid in advance, are taxable in the year received, not in the year earned. The taxpayer's method of pro-rating the dues over a 12-month period was an artificial one,

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Richard S. Helstein, C.P.A., *has been a member of our Society since 1940. He has been a member of the Committee on Federal Taxation, as well as various other committees. He is presently a member of the Committee on Publications.*

Mr. Helstein has contributed to accounting and other publications, and delivered addresses before our Society and other professional societies. He is associated with J. K. Lasser & Co.

and bore no relation to the services rendered. The Court distinguished the *Beacon Publishing Co.* and *Schuessler* cases, without comment upon the correctness of the decisions, on the basis that in those cases the income was reported on the basis of the service rendered. There were three dissents on the grounds that the taxpayer's method of accounting more clearly reflected its income than does the Commissioner's. (*Automobile Club of Michigan v Com.*, Sup. Ct. No. 89, 4/22/57)

Time for Deduction of State Taxes

There has been some procedural conflict in the past in connection with the time for deduction of State taxes by an accrual basis taxpayer, where there have been uncontested adjustments resulting from examination of the Federal income tax returns which also result in an increase in State taxes. Some Internal Revenue Agents have allowed an accrual of the additional State tax in computing the deficiency. In *Jack M. Chesbro et al* (21 TC 123, 130) the Court stated:

"The corporation, using an accrual method of accounting, is entitled to accrue additional franchise taxes based upon any adjustment made by the Commissioner increasing its income which is proper and which it has not contested . . ."

The Commissioner has now ruled that the additional State tax is deductible *only* in the year in which the taxpayer notifies the State of the additional liability. This ruling follows *Gunderson Bros. Engineering Corp.* (16 TC 118) and does not mention *Chesbro* (supra) which is certainly more in point (Rev. Rul. 57-105, IRB 1957-11, 31).

Penalties are Deficiencies in Tax

A penalty is an "addition to the tax," and therefore part of the tax for purposes of determining whether there is a deficiency coming within Tax Court jurisdiction.

Thus, where an overassessment of tax was exceeded by the penalty, the Tax Court had jurisdiction; in another year, where the overassessment exceeded the penalty, the Tax Court did not have jurisdiction.

Even though the overassessment and penalty are stated separately in the notice of deficiency, the amount of each is to be offset against the other to determine whether a deficiency exists (*Charles E. Myers Sr. et al*, 28 TC___ No. 2).

Interpretation of I. R. C.

A District Court has held that where the provisions of the 1939 Code were vague, new wording of a similar section in the 1954 Code could be used to establish Congressional intent.

In this case it was held that a delinquency penalty for late filing of an income tax return was to be assessed in the same manner as a deficiency in tax, thus entitling the taxpayer to a "90 day letter" rather than a "10-day" demand for payment. As a result, the taxpayer is entitled to an administrative determination as to whether the failure to file a timely return was due to reasonable cause. (*Margaret Hackleman* v. *Ralph C. Granquist, Dist. Dir. of I. R.*, U. S. D. C. Ore., 1/7/57).

Section 306 Stock

Where, in a reorganization, a corporation issued "voting common stock" and "non-voting common stock" pro rata for outstanding common stock, and provided for the redemption of the non-voting stock at 110% of its book value

at the corporation's discretion, "the non-voting common stock" constitutes Section 306 stock (Rev. Rul. 57-132, IRB 1957-14, 7). Thus, its sale or redemption will be treated as ordinary income subject to the qualifications and exceptions set forth in Section 306, IRC 1954.

Legal and Executor Services are Separable

Based on the rationale that if an executor had not himself been a lawyer, he would have had to hire a lawyer to perform the services he performed himself, the Ninth Circuit has held that the fees for such special legal services are separable from the executor fees received.

This distinction was necessary in order for the taxpayer to treat the amount received for the special legal services as long-term compensation under Sec. 107, IRC 1939, since the payment for the legal services alone represented less than 80% of the combined legal fees and executor's fees (*Samuel J. Chase et al* v. *Com.*, C.A.-9, 3/25/57, rev'g. 25 TC 398).

Personal Service Contracts

The "proposed regulations", Sec. 1.543-1, classified as personal holding company income, all amounts received under a contract which required the performance of services by a stockholder owning 25% or more of the stock even if "important and essential" services were required by other persons.

Per modification of these regulations, only the amounts received under the contract which are attributable to the stockholder's services will be considered personal holding company income (T.I.R. No. 44, 3/13/57).

Retirement Income of Professional Men

The following extract from Rev. Rul. 57-141, (I.R.B. 1957-15, 6), is quoted verbatim:

"Inasmuch as the amount of capital employed has only an incidental effect on the amount of profits derived from professional fees, the growth of the profession being dependent primarily on the reputation and technical skill of a doctor, dentist or other professional taxpayer, it is held that such capital is not a material income-producing factor in the taxpayer's business. Accordingly, the entire amount received as professional fees, without any reduction for expenses connected with the earning of such income, is considered to be 'earned income' for the purpose of the limitation provided by section 37(d)(2) of the Code. See *Mim.* 3802, C.B. IX-1, 121 (1930)."

Payments to Former Stockholder

The widow of a 50% stockholder in an insurance agency was forced to sell her devised interest in the business to a new party in order to retain the agency franchises. The selling price was found to be a fair one by the Court. However, *in addition*, the widow insisted upon an agreement by the corporation to pay her $100 per month for life. The deductibility of this amount by the corporation was in issue.

The Court found that the corporation was forced to make this agreement in order to persuade the widow to sell her stock and hence there was no intent to make a gift to the widow. It reasoned that expenditures made to protect or promote a taxpayer's business are ordinary and necessary and, therefore, deductible if they do not result in the acquisition of a capital asset.

It was also held that the payments were not disguised dividends to the acquiring stockholder (i.e. payments by the corporation on his behalf to the widow for her stock) because he was a new stockholder and was not a party to the agreement between the widow and the corporation. (*Williams & Waddell Inc.* v. *Pitts*, D.C.S.C., 2/27/57.)

Year of Deductibility of Payment for Past Services

The taxpayer corporation operated during a three-year period with a skeleton staff. Valuable services were performed for it by a 50% corporate stockholder during these prior years. About the time the stockholder acquired the remaining 50% of the taxpayer's stock, it billed the taxpayer $114,000 for its services based upon 10% of the taxpayer's sales over the three-year period. The taxpayer accrued and deducted the full amount in the taxable year in which the bill was received.

The Court found the amount to be reasonable and held that since the taxpayer was on an accrual basis, the amount was deductible in the year claimed. The Court further ruled that since neither the amount nor the formula was agreed upon prior to the year in question, the *full* amount was deductible in the year that the bill was rendered.

On another issue, the Commissioner's contention that there must be a "legal obligation" for payment in order to render an expenditure deductible was denied by the Court (*Waring Products Corp.*, 27 TC No. 114).

Insurance on Lives of Officer-Stockholders

A corporation took no deduction for the payment of insurance premiums on the lives of the two stockholders, who were brothers. Each brother was the beneficiary of the other, and an agreement between them provided that in the case of the death of either, the proceeds from the policies on the life of the deceased should be used by the corporation to purchase the deceased's holding of stock in the corporation. The corporation was not named in the policies.

The Tax Court held that the surviving brother was the real beneficiary of the policies, since the repurchase by the corporation of the decedent's stock would increase the value of the survivor's holdings in the corporation. Therefore, the payment of the insurance premiums constituted income to the stockholders.

This decision is curious, since any time a corporation receives insurance funds, the stockholders benefit, and where the funds are used to repurchase a decedent's stock, both the corporation and the other stockholders benefit. This is discussed, with citations, in the dissenting opinion (*Henry E. Prunier et al*, 28 TC ___ No. 4).

Life Insurance Premiums are not Deductible as Alimony Payments

Payments covering life insurance premiums, pursuant to a property settlement which became part of a divorce decree, made by a taxpayer for the benefit of his divorced wife, are not "periodic payments" under Secs. 71 and 215 IRC 1954 where the policies were not assigned to his wife. Thus they are neither includible in the wife's gross income, nor deductible by the husband. This is so even where the wife is the first beneficiary and where the husband could neither change beneficiaries nor borrow against the policies (Rev. Rul. 57-125, IRB 1957-13, 7).

Official Decisions and Releases

Business Combinations: An Explanation of A.R.B. No. 48 by the AIA Research Department.
Accounting Research Bulletin No. 48: Business Combinations.

Business Combinations

An explanation by the AIA Research Department of the revision of Chapter 7(c) of Accounting Research Bulletin No. 43, recently released as Accounting Research Bulletin No. 48 (reprinted elsewhere in this issue)

The committee on accounting procedure has revised its previous bulletin on business combinations and has published the revision as Accounting Research Bulletin Number 48. The original bulletin was first published in 1950 as Accounting Research Bulletin Number 40, and in 1953 it was included with minor changes as Chapter 7(c) in Accounting Research Bulletin Number 43, *Restatement and Revision of Accounting Research Bulletins.*

The principal purposes of Accounting Research Bulletin Number 40 were to recognize a type of business combination which could be treated as a "pooling of interests," to differentiate it from a "purchase" of one business by another, and to consider the major accounting problems of each. Under the "pooling of interests" concept, the accounts ordinarily are literally merged or combined. The assets are combined and carried forward at their carrying values as are the liabilities, and the earned surplus of each corporation is usually carried forward as part of the earned surplus of the surviving company, which may be a new corporation created for the purpose or may be one of the constituent corporations. The combination is carried out through an exchange of shares of stock so that typically all of the shareholders of the original corporations become shareholders of one corporation. Adjustments are permitted which could properly be made in the absence of a combination; for example, part of the earned surplus might be capitalized in connection with the exchange of shares of stock. In combining the assets, adjustments may be made to state their amounts in conformity with generally accepted accounting principles or to put the assets of the two companies on a uniform accounting basis.

Where, however, the combination is treated as a "purchase," the acquiring company assumes the liabilities and records the purchase of the assets of the acquired business under the usual interpretation of cost, that is, the fair market value of the shares of stock issued plus the cash or other consideration given, or the fair market value of the property acquired, whichever is more clearly evident. Any excess over

the amounts assignable to tangible assets appears as goodwill or under some other appropriate intangible asset title. Only the earned surplus of the acquiring corporation is carried forward. A "purchase" may be carried out solely through an exchange of shares of stock, but ordinarily purchases are characterized by the payment of substantial amounts of cash or other property, or by the issuance of notes or bonds, and a significant part or all of the ownership interest of the acquired business is eliminated.

Former Criteria for Pooling of Interests

A number of considerations were mentioned in Chapter 7(c) of Accounting Research Bulletin Number 43 which were to be taken into account in determining whether or not a combination could properly be treated as a pooling of interests. The most important one was that all or substantially all of the equity interests in the predecessor companies should continue as such in the surviving corporation. It was also felt that the pooling of interests treatment would not be appropriate where one company was quite minor in size in relation to the other. It was assumed that the management of none of the companies would be eliminated nor would its influence upon the management of the surviving corporations be reduced disproportionately. The pooling of interests presumption would be strengthened if the activities of the combined businesses were similar or complementary.

Experience with Chapter 7(c)

Many of the business combinations which have occurred during the past few years have been treated as poolings of interests. The provisions of Chapter 7(c) have, however, been unnecessarily restrictive or indefinite in the opinion of many of those who have been concerned with the accounting for the combinations, and this feeling of dissatisfaction led to the revision which has now been issued.

One of the difficulties has been the implication in Chapter 7(c) that the previously separate businesses are to be carried on in a single corporation, thus ruling out the possibility of continuing one or more of them as subsidiaries. For various reasons, it may be desirable or necessary to carry out the combination under the parent-subsidiary relationship—the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases, or licenses. In some cases a legal combination of corporations organized in two different states cannot be carried out. Chapter 7(c) generally takes the position that the treatment of a combination as a pooling of interests should not be affected by legal technicalities, and it has been felt by some accountants that for all practical purposes a pooling of interests has been accomplished even though two or more legal entities continue in existence. There are no accounting difficulties in such an interpretation; the parent company exchanges its shares of stock for those of the subsidiary and records the investment at the net asset value of the shares of stock as shown on the books of the subsidiary at the date of the combination. In the consolidated balance sheet, the assets and liabilities are combined and ordinarily the sum of the earned surplus of each of the companies becomes the consolidated earned surplus.

The relative size of the companies in combinations which have been treated as poolings of interests has varied a great deal. Forty recent combinations which were so treated were studied by

the research department. With the smaller company's sales in each case stated as a percentage of the larger company's sales in the year prior to the combination, the sales percentages varied all the way from a high of 97 to a low of 2, the median being 47. Chapter 7(c) used the expression "quite minor in size" in suggesting that there should be a lower limit, but it has been felt a more definite "floor" should be specified.

The common practice in modern business organization of including under one corporate entity a group of unrelated products and services has thrown some doubt upon the importance of another provision of Chapter 7(c). It may not be significant, in deciding whether or not a combination qualifies as a pooling of interests, that the activities of one company are not similar or complementary to those of another.

Highlights of the Revision

The continuation in a pooling of interests of one corporation as a subsidiary of the other is now given positive recognition as an appropriate procedure providing no significant minority interest remains outstanding. The new organization is regarded as a continuation of all constituent businesses, whether it is represented by a single corporation or by a parent company and one or more subsidiaries. It is believed that the combination of earned surpluses in the consolidated balance sheet is proper, since a pooling of interests is not an "acquisition" as that term is used in paragraph three of Chapter 1(a) of Accounting Research Bulletin Number 43, which states that earned surplus of a subsidiary company created prior to acquisition does not form a part of the consolidated earned surplus.

There is no change in the concept of continuity of ownership in a pooling of interests, but the phrase "substantially all of the ownership interests" has replaced "substantially all of the equity interests," "ownership interests" referring basically to common stock, although in some cases the term may also include other classes of stock having senior or preferential rights as well as classes whose rights may be restricted in certain respects. As in the previous version, the point is made that when the shares of stock that are received by the several owners of one of the predecessor companies are not substantially in proportion to their respective interests in such predecessor company, a new ownership or purchase of such company is presumed to result. A new point is added that if relative voting rights, as between the constituents, are materially altered through the issuance of senior equity or debt securities having limited or no voting rights, a purchase may be indicated.

As to size, the committee felt that the most important consideration was the relative voting interest in the combined enterprise. It is therefore suggested that where one company is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90 per cent to 95 per cent or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase.

The revision omits the statement in Chapter 7(c) that "the presumption that a pooling of interests is involved would be strengthened if the activities of the businesses to be combined are either similar or complementary."

Since the assumption underlying the pooling-of-interests concept is one of continuity of the separate companies in a combined business activity, it is recognized that the abandonment or sale of the whole or a large part of the

business of one of the combined companies would militate against such treatment of the combination.

The general features of the accounting procedure under a pooling of interests have not been changed, but the point has been added that it would be inappropriate and misleading to eliminate the deficit of one constituent against its capital surplus and to carry forward the earned surplus of another constituent.

The provisions as to financial statements issued in connection with a pooling of interests have been expanded. They now provide that statements of operations issued by the continuing business for the period in which the combination occurs should ordinarily show the results of operations of the combined interests; if combined statements are not furnished, statements for the constituent companies prior to the combination should be furnished separately or in appropriate groups. Results of operations of the several constituents during periods prior to that in which the combination was affected, when presented for comparative purposes, may be stated on a combined basis or shown separately where, under the circumstances of the case, that presentation is more useful and informative.

The revision provides that appropriate disclosure of the accounting treatment of the business combination should be made.

Accounting Research Bulletin No. 48: Business Combinations

Issued by the AIA's Committee on Accounting Procedure, January 1957

1. Whenever two or more corporations are brought together, or combined, for the purpose of carrying on the previously conducted businesses, the accounting to give effect to the combination will vary depending largely upon whether an important part of the former ownership is eliminated or whether substantially all of it is continued. This bulletin differentiates these two types of combinations, the first of which is designated herein as a *purchase* and the second as a *pooling of interests*, and indicates the nature of the accounting treatment appropriate to each type.

2. For accounting purposes, the distinction between a *purchase* and a *pooling of interests* is to be found in the attendant circumstances rather than in the designation of the transaction according to its legal form (such as a merger, an exchange of shares, a consolidation, or an issuance of stock for assets and businesses), or in the number of corporations which survive or emerge, or in other legal or tax considerations (such as the availability of surplus for dividends).

3. For accounting purposes, a *purchase* may be described as a business combination of two or more corporations in which an important part of the ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present.

4. In contrast, a *pooling of interests* may be described for accounting purposes as a business combination of two

or more corporations in which the holders of substantially all of the ownership interests[1] in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations, either directly or through one or more subsidiaries, and in which certain other factors discussed below are present. Such corporation may be one of the constituent corporations or it may be a new corporation. After a pooling of interests, the net assets of all of the constituent corporations will in a large number of cases be held by a single corporation. However, the continuance in existence of one or more of the constituent corporations in a subsidiary relationship to another of the constituents or to a new corporation does not prevent the combination from being a pooling of interests if no signficant minority interest remains outstanding, and if there are important tax, legal, or economic reasons for maintaining the subsidiary relationship, such as the preservation of tax advantages, the preservation of franchises or other rights, the preservation of the position of outstanding debt securities, or the difficulty or costliness of transferring contracts, leases, or licenses.

5. In determining the extent to which a new ownership or a continuity of old ownership exists in a particular business combination, consideration should be given to attendant circumstances. When the shares of stock that are received by the several owners of one of the predecessor corporations are not substantially in proportion to their respective interests in such predecessor, a new ownership or purchase of the predecessor is presumed to result. Similarly, if relative voting rights, as between the constituents, are materially altered through the issuance of senior equity or debt securities having limited or no voting rights, a purchase may be indicated. Likewise, a plan or firm intention and understanding to retire a substantial part of the capital stock issued to the owners of one or more of the constituent corporations, or substantial changes in ownership occurring shortly before or planned to occur shortly after the combination, tends to indicate that the combination is a purchase. However, where a constituent corporation has had two or more classes of stock outstanding prior to the origin of the plan of combination, the redemption, retirement, or conversion of a class or classes of stock having senior or preferential rights as to assets and dividends need not prevent the combination from being considered to be a pooling of interests.

6. Other attendant circumstances should also be taken into consideration in determining whether a purchase or a pooling of interests is involved. Since the assumption underlying the pooling-of-interests concept is one of continuity of all of the constituents in one business enterprise, abandonment or sale of a large part of the business of one or more of the constituents militates against considering the combination as a pooling of interests. Similarly, the continuity of management or the power to control management is involved. Thus, if the management of one of the constituents is eliminated or its influence upon the over-all management of the enterprise is very small, a purchase may be indicated. Relative size of the constituents may not necessarily be determinative,

[1] As used in this bulletin, the term "ownership interests" refers basically to common stock, although in some cases the term may also include other classes of stock having senior or preferential rights as well as classes whose rights may be restricted in certain respects.

especially where the smaller corporation contributes desired management personnel; however, where one of the constituent corporations is clearly dominant (for example, where the stockholders of one of the constituent corporations obtain 90% to 95% or more of the voting interest in the combined enterprise), there is a presumption that the transaction is a purchase rather than a pooling of interests.

7. No one of the factors discussed in paragraphs 5 and 6 would necessarily be determinative and any one factor might have varying degrees of significance in different cases. However, their presence or absence would be cumulative in effect. Since the conclusions to be drawn from consideration of these different relevant circumstances may be in conflict or partially so, determination as to whether a particular combination is a purchase or a pooling of interests should be made in the light of all such attendant circumstances.

8. When a combination is deemed to be a purchase, the assets acquired should be recorded on the books of the acquiring corporation at cost, measured in money, or, in the event other consideration is given, at the fair value of such other consideration, or at the fair value of the property acquired, whichever is more clearly evident. This is in accordance with the procedure applicable to accounting for purchases of assets.

9. When a combination is deemed to be a pooling of interests, a new basis of accountability does not arise. The carrying amounts of the assets of the constituent corporations, if stated in conformity with generally accepted accounting principles and appropriately adjusted when deemed necessary to place them on a uniform accounting basis, should be carried forward; and the combined earned surpluses and deficits, if any, of the constituent corporations should be carried forward, except to the extent otherwise required by law or appropriate corporate action. Adjustments of assets or of surplus which would be in conformity with generally accepted accounting principles in the absence of a combination are ordinarily equally appropriate if effected in connection with a pooling of interests; however, the pooling-of-interests concept implies a combining of surpluses and deficits of the constituent corporations, and it would be inappropriate and misleading in connection with a pooling of interests to eliminate the deficit of one constituent against its capital surplus and to carry forward the earned surplus of another constituent.

10. Where one or more of the constituent corporations continues in existence in a subsidiary relationship, and the requirements of a pooling of interests have been met, the combination of earned surpluses in the consolidated balance sheet is proper since a pooling of interests is not an acquisition as that term is used in paragraph 3 of chapter 1(a) of Accounting Research Bulletin No. 43 which states that earned surplus of a subsidiary corporation created prior to acquisition does not form a part of the consolidated earned surplus. Under the pooling-of-interests concept, the new enterprise is regarded as a continuation of all the constituent corporations and this holds true whether it is represented by a single corporation or by a parent corporation and one or more subsidiaries. If, however, prior to the origin of a plan of combination one party to the combination had been acquired by another such party as a subsidiary in circumstances which precluded the transactions from being considered a pooling of interests, the parent's share of the earned surplus of the subsidiary prior to such acquisition should not be in-

cluded in the earned surplus of the pooled corporations.

11. Because of the variety of conditions under which a pooling of interests may be carried out, it is not practicable to deal with the accounting presentation except in general terms. A number of problems will arise. For example, if a single corporation survives in a pooling of interests, the stated capital of such corporation may be either more or less than the total of the stated capitals of the constituent corporations. In the former event, the excess may be deducted first from the total of any other contributed capital (capital surplus), and next from the total of any earned surplus, of the constituent corporations. When the stated capital of the surviving corporation is less than the combined stated capitals of the constituent corporations, the difference should appear in the balance sheet of the surviving corporation as other contributed capital (capital surplus), analogous to that created by a reduction in stated capital where no combination is involved.

12. When a combination is considered to be a pooling of interests, statements of operations issued by the continuing business for the period in which the combination occurs should ordinarily include the combined results of operations of the constituent interests for the part of the period preceding the date on which the combination was effected; if combined statements are not furnished, statements for the constituent corporations prior to the date of combination should be furnished separately or in appropriate groups. Results of operations of the several constituents during periods prior to that in which the combination was effected, when presented for comparative purposes, may be stated on a combined basis, or shown separately where, under the circumstances of the case, that presentation is more useful and informative. Disclosure that a business combination has been, or in the case of a proposed combination will be, treated as a pooling of interests should be made and any combined statements clearly described as such.

The statement entitled "Business Combinations" was unanimously adopted by the twenty-one members of the committee.

COMMITTEE ON ACCOUNTING PROCEDURE (1956-1957)

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